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Supreme Court of the United States

October Term, 1939.

No. [redacted] 8 4

CRANE-JOHNSON COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE.

Brief Amici Curiae in Support of Petition for Writ of Certiorari.

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Revenue Act of 1936.

Note: The pertinent sections of the Act will be found reprinted in Appendix Exhibit "E," at the following indicated pages thereof.

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Section 26—Credits of Corporations 106

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Section 102—Surtax on Corporations Improperly Accumulating Surplus 110

Note: The corresponding law and subject-matter was section 220 under Revenue Acts of 1921, 1924 and 1926, and labeled in each instance "Evasion of Surtax by Incorporation"; which section became 104

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in the Revenue Acts of 1928 and 1932, and there labeled "Accumulation of Surplus to Evade Surtaxes."

This section (104) being the *penalty for evasion* section, under consideration by Mr. Justice Brandeis in *Helvering* v. *National Grocery Company*, 304 U. S. 282, 82 L. ed. 1346, finally became section 102 in the Revenue Act of 1934, and so remained in the Revenue Act of 1936, notwithstanding the adoption of (new) section 14 of the 1936 Revenue Act of which complaint as to constitutionality is herein made.

Section 115—Distributions by Corporations 112

Note: A(2) of this section is *new matter*, as follows:

> "or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) *without regard* to the amount of the earnings and profits *at* the time the distribution was made.",

highly prejudicial and, we think, unconstitutional in that the definition of *dividends* was extended (over and above all prior definitions) to include distributions out of current earnings without regard to capital impairment or deficits existing at the beginning of the taxable year.

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Note: This section first appeared in the Revenue Act of 1934, and levies a surtax on the undistributed adjusted net income of personal holding companies independent of any question of *reasonable needs of the business* or *purpose* to evade surtax.

The pertinent portions of above numbered sections of Revenue Act of 1936 will be found cited (or quoted) in the brief proper at following indicated pages:

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WASHINGTON STATUTES.

Remington's Rev. Stat. of the State of Washington, sections 3803-24, Laws of 1933, Session Laws 1933, page 785, Sec. 24, Laws of the State of Washington:

"* * * * * * * *

"In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least an-

nually in proportion to their use as may be determined by the Board of Directors.

"4. *No corporation shall pay dividends.*

"a. In cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;

"b. In shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from,

"a. Any profit on treasury shares before resale; or,

"b. Any unrealized profits due to increase in valuation of inventory before sale; or

"c. The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

"d. The unaccrued or unearned portion of any unrealized profit in any form whatever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise * * *."

Remington's Rev. Stat. of the State of Washington, section 3803-25, Laws of 1933, Session Laws 1933, page 787, Sec. 25, Laws of the State of Washington; penalty for violation last above quoted statutes:

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly

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and severally liable to the corporation in an amount equal to the amount of the dividends so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

"a. When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"b. To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by Subdivision 1 of this section. * * *"

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SUPREME COURT OF THE UNITED STATES.
October Term, 1939.

No. 584

CRANE-JOHNSON COMPANY, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI.*

The undersigned, Harry O. Glasser of Enid, Oklahoma, Robert L. Judd of Salt Lake City, Utah, and W. S. Greathouse of Seattle, Washington, of counsel representing taxpaying corporations in Oklahoma, Utah and Washington, having substantial *undistributed corporate profits* for 1936, respectfully suggest that inasmuch as the constitutional *validity* of the provisions of the Revenue Act of 1936 by which a *tax* is imposed upon such corporations, measured by such *undistributed corporate profits* is now pending in the Courts of the Ninth and Tenth Circuits and will necessarily be involved in and affected by the denial of the petition for *certiorari* prayed for in this cause; it is therefore respectfully urged that this brief *amici curiae* be received and considered in this Honorable Court in support of the petition for *certiorari* presented by petitioner.

ARGUMENT.

That portion of the Revenue Act of 1936, which undertakes to *tax undistributed corporate profits,* is unconstitutional in that it levies

(a) a tax upon the corporation for

> "* * * the stockholder's share in the accumulated profits of the company,"

in violation of the "income definition" of the Supreme Court in *Eisner* v. *Macomber,* 252 U. S. 189; 40 Sup. Ct. Rep. 189; 64 L. ed. 521; 3 Am. Fed. Tax Rep. 3020; and in further violation of the "undistributed profit definition" announced in *Willcuts* v. *Milton Dairy Company,* 275 U. S. 215, 72 Law. ed. 248, 48 Sup. Ct. R. 71.

and

is (in the alternative),

(b) *unconstitutional* in that it is a *penalty on conduct* and *actually* represents an effort to "create a conduit to income" by "increasing the velocity of monetary circulation."

(c) That over and beyond the constitutional invalidity of the law for the reasons above indicated, the law is also invalid and unconstitutional in that it discriminates against corporations (such as the Utah Hotel Company) *with no* "earnings or profits *accumulated* after February 28, 1913," in that such corporations are required to pay the tax *unless a dividend* be made

to stockholders which (under such circumstances) would be *solely* a *return of capital.*

(d) Furthermore, the act in its complained of provisions is unconstitutional and invalid in that it is "arbitrary and capricious so as to amount to confiscation and thereby offend the 5th Amendment," by its imposition of a tax upon a corporation which is without *income* in a business sense, as where such corporation sustains (in the taxable year) a nondeductible capital loss in excess of its "taxable net gain;" or *in the alternative* penalizes a corporation for failing to do the impossible, viz., to make *payment* of a *dividend* with nothing on hand out of which to make such payment.

While it is our purpose to briefly discuss the foregoing pronouncements in the order of their statement, it becomes necessary to first give attention to the historical background of the Act.

HISTORICAL BACKGROUND

An able argument for the theory upon which the statute is written, will be found in an article by John B. Martin, Jr., in the Michigan Law Review, Vol. 35, November, 1936, No. 1, page 44, *et seq.*, and while disclaiming responsibility for the *justification conclusions* of that writer, we desire to avail ourselves of his painstaking effort in preparing a comprehensive historical account of the events leading up to the passage of the law.

We quote (without change in quotation marks) from that portion of Mr. Martin's article as follows:

TAXATION OF UNDISTRIBUTED CORPORATE PROFITS*

John B. Martin, Jr.†

Historical Background

The legislation proposed by President Roosevelt in his message of March 3, 1936, to prevent automatic avoidance of taxation by non-distribution of corporate profits, does not represent a new and previously unheard of system of taxation. It embraces, on the contrary, the gist of proposals made by various individuals and organizations extending back as far as the year 1864 when Congress passed a Revenue Act providing that "gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."[1] The Revenue Acts since 1913 have also attempted to deal with the closely related problem of purposeful evasion of surtax by the accumulation of surplus beyond the reasonable needs of the business.[2] In July, 1917, a bill was submitted to the Senate by its Finance Committee[3] containing a section suggested by Senator Jones of New Mexico[4] which levied in addition to normal income tax an additional 15 per cent tax on undistributed net income exempting, however, undistributed profits used for the maintenance of re-

*The material which follows has been limited in scope to a consideration of the new tax on undistributed corporate profits levied by the Revenue Act of 1936. Inevitably some mention has also been required of sections 102 and 351 and their counterparts in previous acts. The attempt has been made to view the principle embodied in the new act from the standpoint both of the lawyer and the economist. The technical accounting problems raised by the act have not been dealt with except as corporate accounting necessarily enters into economic analysis.

†Member of the District of Columbia bar. A. B., Dartmouth; B. Litt., Oxford; J. D., Michigan.—*Ed.*

[1] Act of June 30, 1864, c. 172, 13 Stat. L. 218 at 282, upheld in Collector v. Hubbard, 12 Wall. (79 U. S.) 1 at 17 (1870), and overruled by Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 S. Ct. 912 (1895). See Eisner v. Macomber, 252 U. S. 189 at 217-219, 40 S. Ct. 189 (1920).

[2] See note 26, infra.

[3] 55 Cong. Rec. 4631, 4646 (1917); H. R. 4280, § 1206 (2).

[4] 61 Cong. Rec. 6842 (1921).

serves required by law and 20 per cent of net income directly engaged in the production or distribution of commodities or in banking. This bill was sent back to the committee and altered. A subsequent amendment proposed a flat 10 per cent tax on the amount of undistributed net income retained,[5] but this was modified to apply only to income not retained for actual employment in the reasonable needs of the business.[6]

The statement has often been made that an ideal method would be to tax corporate income as though it belonged to the stockholder whether divided or not.[7] But the decision in 1920 of the United States Supreme Court in *Eisner* v. *Macomber*[8] seems to make this impossible. A tax on stock dividends was involved in that case. The court expressed itself strongly to the effect that "the stockholder's share in the accumulated profits of the company is capital, not income" and cannot be taxed directly without apportionment until distributed as dividends other than stock dividends.

In addition to the pronouncement of the Supreme Court, the year 1920 was also fruitful in suggestions from several sources. The National Association of Credit Men in January, 1920, sent out from its Committee on Federal Taxation a proposal that the corporate income and excess profit taxes be repealed, that the dividends from current earnings be made subject to the normal tax in the hands of individuals and that a tax be levied on the undistributed net income. This tax was to be a graduated tax, each additional 10 per cent of undistributed net income paying a higher tax.[9] In line with this proposal

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[5] 55 CONG. REC. 6175 (1917).

[6] 40 Stat. L. 300 at 334, c. 63, § 1206 (2) (1917).

[7] Remarks of Senator Jones of New Mexico, 65 CONG. REC. 8012 (1924) and 20 PROC. NAT. TAX ASSN., Report of Committee on Simplification of the Income Tax, p. 108 at 133 (1927).

[8] 252 U. S. 189 at 219, 40 S. Ct. 189 (1920), See Justice Brandeis' dissent at pp. 230-232 favorable to taxing the pro rata share of undistributed profits as income. See Revenue Act of 1916, 39 Stat. L. 756, c. 463, tit. I, part I, § 2(a).

[9] Message from the Committee on Federal Taxes of the National Association of Credit Men (January 1920). See remarks of R. G. Elliott, chairman of this committee, in PROC. NAT. IND. TAX CONF. 64-70 (April, 1920), and of Senator Jones of New Mexico, 61 CONG. REC. 6834, 6841, 6845, 6851 (1921). Note that in the recent House proposal the tax was a percentage of adjusted net income and not of undistributed net income. In the bill as finally passed, the tax is a per cent of undistributed net income, the per cent being determined by the per cent of net income undistributed. In both, however, the ultimate reference is to the amount of net income retained by the corporation.

an amendment was offered by Senator Jones of New Mexico,[10] but it was not finally made part of the Revenue Act.

In March, 1920, Secretary Houston of the United States Treasury suggested to the House Ways and Means Committee that a tax on the annual undistributed profits of corporations would be a desirable change in the tax system.[11] The Secretary recognized that this taxed reinvested profits but pointed out that even if unwise economically it was an accepted principle as to sole traders and partnerships, and therefore should be equally applicable to corporations. He felt that if the tax were moderate it would not result in an uneconomic disbursement of dividends.

During the same year the Second National Industrial Tax Conference considered and rejected the idea of a tax on undistributed income "because that . . . would penalize saving, encourage distribution and put an undesirable pressure on the directors of a corporation to pay excessive dividends."[12] It was suggested that an attempt be made to equalize the tax burden and to tax the undistributed income by increasing the normal income tax and providing for partial abatement of the tax on individual income reinvested. At this same conference the Tax Committee of the National Conference of State Manufacturers' Associations presented a plan differing in that it proposed a progressive tax upon undistributed net income based upon (a) the amount of invested capital, and (b) the ratio of undistributed net income to invested capital.[13]

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[10] 61 CONG. REC. 6834, 6841 ff. (1921).

[11] This suggestion was included in the ANNUAL REPORT OF THE SECRETARY OF THE TREASURY 39-43 (1920). Both flat and graduated taxes were suggested as alternatives. It was also suggested that if a progressive tax was used the total surtax should never exceed 20 per cent of the undistributed profits.

[12] PROC. SECOND NAT. IND. TAX CONF. 7, 170, 172-174 (Oct., 1920).

[13] In addition it was proposed (1) to attempt no change in the general principle involved under then existing law in taxing individuals (other than stockholders), sole proprietors and partnerships, (2) to withdraw the existing exemption from normal tax on dividends received from corporations, (3) to exempt corporations from any normal income tax. Compare this plan with the House proposal to differentiate between corporations on the basis of the amount of income earned. Roughly, perhaps, the amount of invested capital may be thought to be proportionate to the amount of net income in ordinarily prosperous times. Remarks of J. F. Zoller, PROC. SECOND NAT. IND. TAX CONF. 134-139, 187 (Oct. 1920).

By 1923 Dr. T. S. Adams[14] was saying to the National Tax Association in relation to the discrepancy between taxation of partners and corporations: "In consequence, we have all sorts of proposals to lay additional tax on the undistributed profits of corporations. . . . I do not quarrel with this rejection of the proposal to treat corporations like partnerships. . . ."[15] He continued,

> "We reject an exact solution of this problem . . . because when we face the issue squarely we conclude that it would be inadvisable to put a premium on the complete distribution of corporate profits.[16] We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the saving made by corporations . . . that part of the business income of the country [representing savings] cannot stand surtaxes rising to fifty per cent."[17]

In 1924 an amendment was again offered by Senator Jones and was accepted by the Senate, 43 to 32, which imposed, in addition to a 9 per cent normal tax on corporate income, a graduated tax on undistributed net income beginning at one-half of one per cent of undistributed net income when the undistributed net income was more than 10 but less than 11 per cent of surtax net income. The taxing framework bore a

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[14] Former Chairman of the Advisory Tax Board of the Bureau of Internal Revenue. Dr. Adams' opinion is quoted because there has been considerable controversy as to the position which his long study of tax problems led him to take on the principle of taxation of undistributed corporate earnings. See testimony of G. O. May, S. Hearing on H. R. 12395, 74th Cong., 2d Sess., p. 542 (1936).

[15] 16 Proc. Nat. Tax Assn. 308-309 (1923).

[16] Dr. Adams had changed his earlier position. A U. S. Treasury memorandum entitled, "Treatment of Business Income and of Attempts to Prevent the Escape of Taxes through the Retention of Corporation Earnings," (1936) states that Dr. Adams "as early as 1918 went on record in favor of the taxation of undivided profits at the rates which would apply if such profits were distributed to the shareholders. . . . The same thought was behind his recommendation in 1920 to the Second National Industrial Tax Conference that the corporation income tax be raised from 10% to 16%, and his proposal in substance became a part of the Majority Report of the Conference Board's Tax Committee."

[17] In this same address Dr. Adams suggests a *progressive* tax on spending as the alternative to the principle which he rejects.

marked resemblance to that of the recently adopted act.[18] This amendment was eventually eliminated from the bill in conference.

More recently still the conference of the National Tax Association has fallen in with the suggestion for a tax on undistributed corporate profits.[19] The position was taken that, in view of the practice by which sole traders and partners are taxed on their reinvested income,[20] we ought to return "to the idea that a corporation is merely a conduit through which income passes and that the only recipient who should be taxed is the natural person as stockholder, who enjoys the income earned by the corporation."[21] The Association recommended that the tax be a flat 10 per cent of the amount of net income for the year in excess of dividends paid and that it be considered as a *premium tax* paid by the corporation for its stockholders in exchange for the privilege of retaining the earnings in the business, thereby postponing the normal tax and surtax until a future day.[22] It was pointed out that this "gentle but steady pressure" upon the directors would lead them, as the persons best qualified to judge of the needs of the business, "to pare the surplus down to actual needs and reasonable requirements."[23] The Association takes care to point out that the pressure must be a "gentle" one and the tax "reasonable."

In 1928 the Joint Committee on Internal Revenue Taxation, headed by L. H. Parker, considered the question and, in a

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[18] It is interesting to compare this amendment with the present Revenue Act. See 65 CONG. REC. 8032 (1924); H. R. 6715, 68th Cong., 1st sess. (1924), in Senate pp. 85-93.

1924 AMENDMENT	PRESENT TAX
Surtax Net Income: Net income plus interest received from Federal bonds not exempt from surtaxes plus income from other corporations.	*Adjusted Net Income:* Net income less normal tax less interest received on obligations of the United States.
Undistributed Net Income: Surtax net income less normal tax and cash dividends paid during year.	*Undistributed Net Income:* Adjusted net income (from which the normal tax has been deducted) less credit for dividends paid less credit for contracts restricting dividends.

[19] 20 PROC. NAT. TAX ASSN., Report of Committee on Simplification of the Income Tax, pp. 108-167 (1927).

[20] See §§ 181-183 Revenue Act of 1934, 48 Stat. L. 730. Compare with recommendations of Secretary Houston, note 11, supra.

[21] 20 PROC. NAT. TAX ASSN. 133 (1927).

[22] 20 PROC. NAT. TAX ASSN. 133-134 (1927).

[23] 20 PROC. NAT. TAX ASSN. 136-137 (1927).

report concurred in by the Advisory Committee of which Dr. Adams was a member, rejected an undistributed profits tax. The Committe pointed out,

> "The most obvious objection to such a tax is the burden which it places on legitimate and proper business expansion. As a business expands not only does its plant and property increase but a larger working capital is required and it is desirable that reasonable accumulation of profits necessary for the expansion and stability of corporations should not be unduly burdened."[24]

That the present plan was in the mind of the President prior to his message of March 3, 1936, is indicated from the recommendations made but not elaborated upon on June 19, 1935, in the President's message to Congress. The President then said, "We should likewise discourage unwieldy and unnecessary corporate surpluses."[25]

To complete the historical picture it is necessary to advert to past legislation by which Congress has sought to prevent the accumulation of surpluses and evasion of taxation. The method first employed disregarded the corporate entity and sought to tax the individual for his pro rata share in corporate income, whether distributed or not, as though it had been distributed, where the corporation was formed or availed of for the purpose of evading taxation through accumulation of gains and profits.[26] This approach to the problem was retained until 1921 when a change in principle was made whereby a penalty tax was assessed against the corporation. In the 1934 act this was made applicable where the corporation is formed or employed for the purpose of preventing the imposition of the surtax upon its shareholders or upon those of any other corporation through the device of allowing gains and profits to accumulate instead of being distributed.[27] It should

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[24] REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 54, 70th Cong., 1st Sess. (1927).

[25] 79 CONG. REC. 9713 (1935).

[26] Revenue Act of 1913, § II (A) 2, 38 Stat. L. 166; Revenue Act of 1916, § 3, 39 Stat. L. 758; War Revenue Act of 1917, § 3, 40 Stat. L. 301; Revenue Act of 1918, § 220, 40 Stat. L. 1072.

[27] Revenue Act of 1934, §102, 48 Stat. L. 702. See also § 220 of Revenue Acts of 1921, 1924, 1926, 42 Stat. L. 247, 43 Stat. L. 277, 44 Stat. L. 34; § 104 of Revenue Acts of 1928, 1932, 45 Stat. L. 814, 47 Stat. L. 195. For complete

be noted that the purpose to evade taxation is here of prime importance. Without it no tax is imposed. But the purpose need not be fraudulent. The fact that gains or profits are allowed to accumulate beyond the reasonable needs of the business is made prima facie evidence of purpose to avoid the surtax.[28] This has been interpreted as not preventing ordinary business expansion.[29] Included in reasonable needs of the business are (1) adequate working capital, (2) additions to plant reasonably required, (3) additions to sinking fund for bond retirement.[30] Nor is it unreasonable to take into account in accumulating reserves the hazards of the particular business, its normal rate of expansion unemployment insurance, or employee benefits. It would also seem reasonable to allow accumulation to offset fluctuations in the wage scale and to cover bad accounts receivable. On the contrary, accumulations for the purpose of buying stock and bonds of other corporations with which the business of the purchasing corporation has no obvious relation is unreasonable accumulation.[31]

Two factors are of especial significance in relation to this method of preventing tax avoidance. First, it has been very difficult to enforce because a purpose to avoid the surtax is hard to show either directly or by the prima facie presumption arising from accumulation beyond the reasonable needs of the business. What is reasonable may depend upon dozens of factors, and equally sane men may differ widely on the question as regards any given business. It seems to be generally admitted that the statute has been in many respects a dead letter.[32] Because its penalty is severe, the natural tendency

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discussion of these acts, see 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 48.26-48.35 (1934); Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 19, 78 (1935); Lang, "Surtaxes on 'Personal Holding Companies' and 'Corporations Improperly Accumulating Surplus'," 13 TAX MAG. 274 (1935).

[28] Revenue Act of 1934, § 102 (b), 48 Stat. L. 702.

[29] Wm. C. DeMille Productions, Inc., 30 B. T. A. 826, 31 B. T. A. 1161 (1934).

[30] TREAS. REG. 86, art. 102-3.

[31] Statement of Assistant General Counsel of Bureau of Internal Revenue, Dec. 13, 1934. See 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, Supp., 71-72 (1935).

[32] 65 CONG. REC. 8014 (1924). Senator Jones of New Mexico remarked, "It is admitted by everybody, and the Secretary of the Treasury in his testimony stated that he had not found a single corporation which had violated that provision of the law."

has been to enforce it in extreme cases only.[33] In the last fifteen years not more than ten cases have arisen under this section of the act. The criticism is perhaps justified that this method of dealing with accumulated surplus is "cracking nuts with sledge hammers."[34] Second, it is to be observed that the tendency in enforcing the act has been to avoid encouraging unorthodox business practices. The practice has been to consider every fact which a prudent business man would consider as bearing on the question of reasonableness of accumulation.[35]

The problems of proof involved in section 102 led in 1934 to the enactment of section 351 dealing with personal holding companies. This section defines a personal holding company in terms of (1) sources of income, and (2) stock ownership.[36] It levies a surtax upon the undistributed adjusted net income of such companies independent of any questions of reasonable needs of the business or purpose to avoid surtax.[37] It should be noted that though provision is made for the exemption from tax in the hands of the corporation of dividends paid during the year,[38] there is no provision under either section 102 or section 351 for the exemption from a second tax on earnings which have been taxed in the corporation's hands as undistributed and which are subsequently distributed. This may result in very heavy double taxation. It is conceivable that such a result is justified under section 102, where a purpose to avoid taxes is the basis for the penalty, but it is difficult to justify under section 351 where no such purpose need exist.[39] It is true

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[33] Revenue Act of 1934, § 102 (a), 48 Stat. L. 702, takes as tax 25 per cent of the adjusted net income not in excess of $100,000 plus 35 per cent of that in excess of $100,000, in addition to the normal corporation income tax running as high as 15 per cent in the 1935 act. For an illustration of the possible burden of this tax, see Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 78 at 81-82 (1935).

[34] 20 PROC. NAT. TAX ASSN. 134 (1927).

[35] Statement of Assistant General Counsel of Bureau of Internal Revenue, Dec. 13, 1934. See 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, Supp. 71-72 (1935).

[36] Revenue Act of 1934, § 351 (b) (1), 48 Stat. L. 751.

[37] TREAS. REG. 86, art. 351-1.

[38] This applies to corporations under both sections 102 and 351. See Revenue Act of 1934, § 102 (c) and 351 (b) (2) (C), 48 Stat. L. 702, 751.

[39] See criticism of such a situation by R. G. Elliott, Chairman of Committee on Federal Taxation of National Association of Credit Men. PROC. SECOND NAT. IND. TAX CONF. 125 (Oct. 1920). Also see Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 78 at 82, 84 (1935).

that both sections allow the stockholder to avoid this double tax by reporting his pro rata share of adjusted net income, if *all* the stockholders in the corporation do likewise. Because the unanimous action of all the stockholders is requisite,[40] this is not a complete solution for the individual stockholder.

It is to be observed that though operating companies may come under the specific definition of section 351 if they have investments, the return on which equals 80 per cent of gross annual income,[41] the section is primarily aimed at holding rather than operating companies.[42] Furthermore, section 102, while applicable to operating companies, has not been enforced against them.[43] These facts have especial meaning in their indication that the economic and legal effects of sections 102 and 351 in their present and earlier forms cannot be regarded as comparable to the effects which may be expected from the Revenue Act of 1936. The former sections in practice have affected only *holding* companies. The surtax on undistributed profits in the Revenue Act of 1936 is in addition to these sections and purports to affect all *operating* companies with certain specified exceptions. The argument that the holding company serves no useful economic purpose cannot be made as to the operating company if it should be found that the new law will operate to the harm of the companies taxed.

While there are in Mr. Martin's article quite a number of digressions from a recitation of a strictly historical background, it was thought best to quote that portion of the article in its entirety, rather than to undertake to delete what might be assumed to be an unimportant part thereof.

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[40] Revenue Act of 1934, § 102 (d), § 351 (d), 48 Stat. L. 702, 752, as amended by Revenue Act of 1935, § 109, 49 Stat. L. 1020. See text, infra, p. 62, regarding an additional obstacle put in the way of such pro rata reporting under the Revenue Act of 1936, § 102 (d) and § 351 (d).

[41] 361 CCH Federal Tax Service 679E-679I.02, assuming, of course, that the requisite stock ownership also exists.

[42] Note 27, supra, Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 (1935).

[43] Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 at 120 (1935). "The effective enforcement of the statute is practically limited to nonoperating companies such as personal holding or investment companies."

Without further comment, we proceed to a consideration of the subdivision of the constitutional question, stated supra (p. 2) as,

(a) that,

> **"That portion of the Revenue Act of 1936 which undertakes to tax undistributed corporate profits is unconstitutional in that it is an effort to tax the corporation for 'the stockholder's share in the accumulated profits of the company'."**

We rest this statement of position upon the authority of *Eisner* v. *Macomber,* supra, *Willcuts* v. *Milton Dairy Company, supra,* and

> *Towne* v. *Eisner,* 245 U. S. 418, 38 Sup. Ct. Rep. 158, 62 L. ed. 372; 3 Amer. Fed. Tax Rep. 2959.

See also:

> *United States* v. *Safety Car Heating Company,* 56 Sup. Ct. Rep. 353, 297 U. S. 88-101, 80 Law. Ed. 500, 16 Amer. Fed. Tax Rep. 1311;

Where Mr. Justice Cardozo (headnote 5) stated:

> "* * * Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital *not* the *potency of fruition.* With few exceptions, if any, it is *income* as the word is known in the common speech of man.
>
> Lynch v. Hornby, 247 U. S. 344, 62 Law ed. 1151, 58 Sup. Ct. Rep. 543.
>
> "* * * When it is *that* it may be taxed, though it was in the making long before."

In an article in the Yale Law Journal, by Homer Hendricks (page 18, Volume 46, November, 1936, Number I), it is said:

"No part of the Revenue Act of 1936 has excited more general interest than that imposing the surtax on undistributed profits of corporations. The tax is *new, untried* and *complicated;* the provisions imposing it *were hastily drawn.*

"One need not here dwell on its importance as a matter of *tax technique* or *social policy.* It is enough to say that under it rates are dependent *on what the corporation does or fails to do* with its income during the taxable year, and that if action *along prescribed lines is not or cannot be taken* the resulting tax may be very large." (Italics supplied.)

At pages 48 to 50 inclusive of the same article, Mr. Hendricks concludes as follows:

"A redefinition of 'income' may be required if this tax is sustained. For the undistributed profits surtax is not imposed on the receipt of income, but on the disposition which a corporation makes of its income. The question here is whether an income tax must necessarily be imposed only with respect to income receipts and not with respect to income disbursements. A tax on spending, generally imposed on all spending and at rates varying according to the spending which Congress desired to encourage or discourage would, runs the argument, not be sustainable as a tax on 'income.' It is argued that a tax may not, unless clearly necessary to prevent evasion of the ordinary tax on incomes, be imposed as a result of the use which a taxpayer makes of the income. When the question reaches the courts, more analysis will be required than has as yet been made in any of the decisions regarding the nature of the income tax and the powers which Congress has with respect thereto. The income tax is in its nature an excise.[110] Heretofore it has been imposed in respect of the receipt of income; whether, if imposed on disbursement or failure to disburse in a specified way, it becomes something other than a tax on income remains to be decided.

The counter argument to the effect that the tax is imposed 'upon net income'[111] although 'measured' by the amount of the

110. Brushaber v. Union Pacific R. R., 240 U. S. 1, 16-17 (1916).
111. See § 14 (b).

undistributed net income[112] appears to have little force. Even if the denomination by Congress of the tax as a 'Surtax on Undistributed Profits'[113] be disregarded, the purpose of Congress was, clearly, to force the distribution of profits, and for all practical purposes the tax is imposed on the undistributed portion of the profits.[114]

It is often contended that the tax is necessary in order to force the distribution of profits to stockholders and thus make effective the surtax on individuals, thereby promoting equality of taxation of income from business, whether derived from corporations, partnerships, or sole proprietorships. It is to be noted, however, that the surtax in question, unlike that imposed by Section 102 (the accumulation of earnings or profits beyond the reasonable needs of the business and with intent to avoid the imposition of the surtax on shareholders) and the surtax imposed by Section 351 (personal holding companies), is directed against the innocent as well as the guilty. It is the common experience of the business world that the amount of 'tax avoidance' which the surtax is professedly designed to prevent is infinitesimal as compared with cases where earnings are retained, not to minimize taxes, but for purposes of expansion, increase of working capital and for other ends which the business world has regarded as legitimate, although it is now said that financing out of earned surplus results in a misdirection of resources, and should be replaced by financing on the open markets. Whether or not critics are right in viewing the American practice of reinvesting surplus as uneconomic, and whether or not the Federal Government has constitutional power to change the business policy of every corporation in the country by virtue of a new tax, are issues immaterial to the question of how far Congress may go in its anxiety to prevent tax avoidance. The cases in which the Supreme Court has given weight to the prevention-of-tax-avoidance argument have involved notorious devices directly affecting the flow of the revenue.[115]

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112. *Cf.* Art. 14-1.

113. See § 14, headline. See also p. 1, *supra.*

114. For the disposition of an analogous contention, see Nichols v. Coolidge, 274 U. S. 531, 540-541 (1927).

115. Thus, amendments to the estate tax provisions taxing certain kinds of tax avoidance transfers have been sustained, Milliken v. United States, 283 U. S. 15 (1931); and provisions having to do with trusts and other trans-

And it must be conceded that there are serious deficiences in the Act as it now stands from the point of view of that arbitrariness of incidence which may be considered violative of due process.[116] The argument of due process would have considerable force, especially if raised in cases involving situations where imposition of the tax is made on a corporation which has no income in the business sense during the year, or where the tax results in very great hardship, even penalizing the corporation for not doing what may be impossible; for example, cases in which the corporation has a non-deductible capital loss in excess of its taxable 'net income,' or where a corporation is unable to meet its debts at maturity if a portion of its earnings and profits be not accumulated for that purpose. Further, the Act contains no provision exempting from the surtax on undistributed profits a corporation which has a surplus deficit and which, therefore, is prohibited by state law from the payment of dividends. But in this case, hardship to the corporate taxpayer can sometimes be avoided by a recapitalization,[117] or by a revaluation of assets or by the reduction or elimination of various kinds of reserves, with corresponding adjustments to the surplus account. If the financial condition of the corporation is serious enough, it might even be put into receivership or bankruptcy.[118]

Other illustrations of the force of this accusation of arbitrariness have been given as the article progressed. In some cases, it is true, where the Act may on casual study seem to operate inequitably, a means may often be found within its terms of avoiding serious hardship.

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actions directly affecting the productiveness and the equality of the burden of the income tax, Taft v. Bowers, 278 U. S. 470 (1929); Corliss v. Bowers, 281 U S. 376 (1930); Reinecke v. Smith, 289 U. S. 172 (1933); Burnet v. Wells, 289 U. S. 670 (1933); DuPont v. Commissioner, 289 U. S. 685 (1933).

116. "That a federal statute passed under the taxing power may be so arbitrary and capricious as to cause it to fall before the due process of law clause of the 5th Amendment is settled." Mr. Justice Sutherland in Heiner v. Donnan, 285 U. S. 312, 326 (1932), citing Nichols v. Coolidge, 274 U. S. 531 (1927), Brushaber v. Union Pacific R. R., 240 U. S. 1 (1916), Tyler v. United States, 281 U. S. 497, 504 (1930).

117. For example, by reducing the par or stated value of the shares, or converting par stock into no par stock (with an appropriate credit in either case to the surplus account), or by having shareholders surrender the necessary number of shares for retirement.

118. See p. 21, *supra*.

Thus, where a corporation has not sufficient cash with which to pay dividends, the corporate taxpayer may pay dividends in obligations [119] or in kind [120] in order to get a dividends-paid credit. The declaration of an optional stock dividend [121] or the payment of a taxable stock dividend [122] is also sufficient. The procedure whereby a cash dividend is paid, and followed by a subscription by the shareholders to additional stock in the corporation may possibly be advised; it was cited with approval as a means of relief by two important Treasury witnesses in the hearings on the Bill.[123] The payment of a cash dividend and the immediate repayment of the same by all the shareholders as a loan to the corporation should perhaps be avoided.[124] Likewise, where the corporation realizes a large gain, for example, on a sale of property, and the proceeds are not in a form which is easily distributable to shareholders, it is possible for the corporation to transfer the desired amount of the proceeds to a newly organized corporation and pay a dividend in shares of the stock of the new corporation."

In *Eisner* v. *Macomber, supra,* Mr. Justice Pitney defined *income* for *income tax purposes* within the Sixteenth Amendment, and what was there said has not since been modified in any particular, nor has there been any improvement (in any other published decision) upon the context of that far-reaching and able opinion.

We quote those portions of that opinion, which we believe to be pertinent; viz.,

> "This case presents the question whether, by virtue of the 16th Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in

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119. See p. 37, *supra.*

120. See p. 41, *supra.*

121. See p. 35, *supra.*

122. See p. 38, *supra.* There may be serious problems of valuation in all these cases, however.

123. See *Hearings before the Committee on Finance on H. R.* 12395, 74th Cong., 2d Sess. (1936) 30-31, 36, 918.

124. Where the loan is evidenced by obligations, the net effect of the transaction would be that the dividend was paid in that form. As to cases where the accounts of the stockholders are merely credited, see p. 31, *supra.*

good faith against profits accumulated by the corporation since March 1, 1913.

"It arises under the Revenue Act of September 8, 1916 (chap. 463, 39 Stat. at L. 756 et seq., Comp. Stat., sec. 6336a, Fed. Stat. Anno. Supp. 1918, p. 312), which, in our opinion (notwithstanding a contention of the government that will be noticed), plainly evinces the purpose of Congress to tax stock dividends as income.

"The facts, in outline, are as follows:

"On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

"Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 per cent, or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the commissioner of internal revenue having been disallowed,

she brought action against the collector to recover the tax. *In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated art. 1, sec. 2, cl. 3, and art. 1, sec. 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the 16th Amendment. A general demurrer to the complaint was overruled upon the authority of Towne* v. *Eisner, 245 U. S. 418, 62 L. ed. 372, L.R.A. 1918D 254, 38 Sup. Ct. Rep. 158; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.*

"* * * * * * *

"We are constrained to hold that the judgment of the district court must be affirmed: First, because the question at issue is controlled by Towne v. *Eisner, supra; secondly, because a re-examination of the question, with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.*

"In *Towne* v. *Eisner,* the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913 (chap. 16, 38 Stat. at L. 114, 166, Comp. Stat., sec. 5291, 2 Fed. Stat. Anno., 2d ed., p. 724), which provided (sec. B, p. 167) that net income should include 'dividends,' and also 'gains or profits and income derived from any source whatever.' Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the district court sustained a demurrer to the complaint. 242 Fed. 702. The court treated the construction of the act as inseparable from the interpretation of the 16th Amendment; and, having referred to Income Tax Cases (Pollock v.

Farmers' Loan & T. Co.), 158 U. S. 601, 39 L. ed. 1108, 15 Sup. Ct. Rep. 912, and quoted the Amendment, proceeded very properly to say (p. 704): 'It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, *and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income.*' * * * * *

"* * * * * * *

"* * * We ruled at the same term, in Lynch v. Hornby, 247 U. S. 339, 62 L. ed. 1149, 38 Sup. Ct. Rep. 543, that a cash dividend extraordinary in amount and in Peabody v. Eisner, 247 U. S. 347, 62 L. ed. 1152, 38 Sup. Ct. Rep. 546, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the Amendment. In the former case, concerning 'corporate profits that accumulated before the act took effect,' we declared (pp. 343, 344): 'Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. . . . Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing.' In Peabody v. Eisner (pp. 349, 350), we observed that the decision of the district court in Towne v. Eisner had been reversed 'only upon the ground that it related to a stock dividend which in

fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest;' and we distinguished the Peabody Case from the Towne Case upon the ground that 'the dividend of Baltimore & Ohio shares was not a stock dividend, but a distribution in specie of a portion of the assets of the Union Pacific.'

"Therefore, Towne v. Eisner cannot be regarded as turning upon the point that the surplus accrued to the company before the act took effect and before adoption of the Amendment. And what we have quoted from the opinion in that case cannot be regarded as obiter dictum, it having furnished the entire basis for the conclusion reached. *We adhere to the view then expressed, and might rest the present case there; not because that case in terms decided the constitutional question, for it did not; but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.*

"Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. at L. 757, chap. 463, Comp. Stat., sec. 6336b, Fed. Stat. Anno. Supp. 1918, p. 312) that a 'stock dividend shall be considered income, to the amount of its cash value,' *we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.*

"The 16th Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the Amendment was adopted. In Income Tax Cases (Pollock v. Farmers Loan & T. Co.) 158 U. S. 601, 39 L. ed. 1108, 15 Sup. Ct. Rep. 912, under the Act of August 27, 1894 (chap. 349, sec. 27, 28 Stat. at L. 509, 553), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the

property from which such income arose, imposed by reason of ownership; *and that Congress could not impose such taxes without apportioning them among the states according to population, as required by art. 1, sec. 2, cl. 3, and sec. 9, cl. 4, of the original Constitution.*

"Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the 16th Amendment was adopted, in words lucidly expressing the object to be accomplished: 'The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.' As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. Brushaber v. Union P. R. Co., 240 U. S. 1, 17-19, 60 L. ed. 493, 501, 502, L. R. A. 1917D, 414, 36 Sup. Ct. Rep. 236, Ann. Cas. 1917B, 713; Stanton v. Baltic Min. Co., 240 U. S. 103, 112, et seq., 60 L. ed. 546, 553, 36 Sup. Ct. Rep. 278; William E. Peck & Co. v. Lowe, 247 U. S. 165, 172, 173, 62 L. ed. 1049-1051, 38 Sup. Ct. Rep. 432.

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be *extended by loose construction, so as to repeal or modify, except as applied to income,* those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This *limitation* still *has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts.*

"In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is

not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. *Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.*

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; * * *"

"* * * 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived,—*'derived—from—capital;'—'the gain—derived—from capital,'* etc. Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth*, or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived,'* that is, *re-*

ceived or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description.

"The same fundamental conception is clearly set forth in the 16th Amendment—'incomes, *from* whatever *source derived*,'—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

"* * * * * * *

"Throughout the argument of the government, in a variety of forms runs the fundamental error already mentioned—a failure to appraise correctly the force of the term 'income' as used in the 16th Amendment or at least to give practical effect to it."

"* * * * * * *

"Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, 245 U. S. 418, 62 L. ed. 372, L. R. A. 1918D, 254, 38 Sup. Ct. Rep. 158, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that, by the true construction of the Act of 1916, the tax is imposed not upon the stock dividend, but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation, the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

"That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interest might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

"The government relies upon The Collector v. Hubbard (Brainard v. Hubbard) (1870) 12 Wall. 1, 17, 20 L. ed. 272, 278, which arose under sec. 117 of the Act of June 30, 1864 (chap. 173, 13 Stat. at L. 223, 282, Comp. Stat., sec. 6368, 4 Fed. Stat. Anno., 2nd ed., p. 324), providing that 'the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.' The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends, and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (p. 18): 'Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends; that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees.' In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Income Tax Cases (Pollock v. Farmers Loan & T. Co.) 158 U. S. 601, 627, 628, 637, 39 L. ed. 1108, 1122, 1125, 15 Sup. Ct. Rep. 912. Conceding The Collector v. Hubbard was inconsistent

with the doctrine of that case, because it sustained a direct tax upon property not apportioned among the states, the *government nevertheless insists that the 16th Amendment removed this obstacle, so that now the Hubbard Case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind.* Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder *has no individual share in accumulated profits,* nor in any particular part of the assets of the corporation, prior to dividend declared.

"Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the 16th Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it,* as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, sec. 2, cl. 3, and article 1, sec. 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the 16th Amendment." (Italics supplied.)

It may be that a more inclusive definition for *income* will be written but until done, the opinion in *Eisner* v. *Macomber, supra,* states the limitations upon the term. The provisions of the 1936 Revenue Act which tax to the corporation its *undistributed accumulated profits* for the failure to declare a *dividend* thereof, is unconstitutional and must fall for the failure to apportion such tax among the several states. Such conclusion is inescapable where (as in the Utah Hotel case, Appendix Exhibit "A") the corporation has an "impaired capital" as a result of an "operating deficit," for as said by Mr. Justice San-

ford in *Willcuts* v. *Milton Dairy Company, supra,* * * * "where capital is impaired, profits though earned and remaining in the business if *insufficient* to 'off-set' this impairment *do not* constitute 'undivided profits'." A more decisive statement could not be framed.

(b) That portion of the Revenue Act of 1936, which undertakes to tax the corporation for its undistributed corporate profits is (in the alternative) unconstitutional in that it is a penalty on conduct and in actuality represents an effort to "create a conduit to income" by "increasing the velocity of monetary cirulation."

It is conceded that Congress has the power under the Sixteenth Amendment to put a tax (of whatever proportion may be necessary for the operation of the government) upon the *income* of a corporation with net earnings. That is an *income tax* and is *constitutional.*

Furthermore, it has the sanctity of equality of treatment to all *corporate taxpayers.*

To plan a *devious* course, such as here complained of, *indicates* a *purpose* (such as in the Child Labor Cases, *infra,* p. 48) to *regulate economic conduct* under the *thin guise of raising revenue.*

There are but two considerations upon which the *tax* in question can be found to be an income tax; viz.,

(1) Congress has so named the Act,

and,

(2) that,

> "* * * a penalty measured by failure to disburse *undistributed* profits is a tax upon *net* income."

Upon subdivision (1) supra, there is presented the same "short question" that was before the United States Supreme Court in *St. Louis Cotton Compress* v. *Arkansas,* 260 U. S.

346, 67 L. ed. 297, where Mr. Justice Holmes, after observing (260 U. S., page 348)

> "The short question is whether this *so-called* tax is *saved* because of the name given to it by the statute, . . ." (Italics supplied.)

concluded,

> "* * * that the name given by the state to the imposition is not conclusive.";

and in the ultimate rule announced that, the name *did not save the Act.*

See also:

St. Louis S. W. Ry. Co. v. *Arkansas, ex rel. Norwood,* 235 U. S. 350-362, 59 L. ed. 265-271, 35 Sup. Ct. Rep. 99.

Subdivision (2), *supra,* presents the crux of the argument, and requires some notice of the economic problem involved.

In this connection we quote further from the article by John B. Martin, Jr., in the Michigan Law Review (cited supra) in the discussion of:

"Motivation for the Present Legislation

The motives behind the present bill are several. The primary motive is, of course, to raise additional revenue. A related fiscal motive is to prevent tax evasion; the attempts to prevent evasion, under sections 102 and 351, have not been successful." Motives which may be termed social and political aim at equalization of the tax burden between sole traders or

" Tax Message of President to Congress, March 3, 1936, 80 Cong. Rec., No. 45, p. 3235 (1936). Testimony of G. T. Helvering, S. Hearing, on H. R. 12395, 74th Cong., 2d sess., p. 22 (1936), showing possibility of evasion either in the payment of dividends in years when other income is small or in the fact that capital gains realized upon sale by reason of increased value of stock due to accumulation of earnings in surplus need be recognized only in part if the stock has been held for more than one year. It is also true that earnings which are now taxed might in the past never have paid a tax if carried to surplus but subsequently dissipated by bad management.

partners and corporate stockholders[45] and at forcing distribution of corporate profits to stockholders.[46] It may also be urged that the present tax plan seeks to help small business[47] and to check corporate bigness.[48] Finally, it has been suggest-

[45] Tax Message of President to Congress, March 3, 1936, 80 CONG. REC., No. 45, p. 3235 (1936). See testimony of Secretary Morgenthau, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 5 (1936); and G. T. Helvering, ibid., p. 19. See proposal of National Association of Credit Men, 61 CONG. REC. 6851 (1921). This point appears sound and has the support of tax experts, but the problem cannot be oversimplified. The proposal to tax the corporation on income undistributed at the same rate that such income would be taxed if in the hands of stockholders cannot be achieved by any blanket schedule of rates such as are used in the Revenue Act of 1936. [On this point, see remarks of T. S. Adams, 16 PROC. NAT. TAX ASSN. 308 (1923).] Inevitably, except in fortuitous instances, the rates will result in a tax higher or lower than the *particular* individual would pay if he received the income in dividends. In general, the result would appear to be that men in the small surtax brackets will suffer most from the undistributed profits tax if the corporation retains any sizable portion of its income. The proposal of the House bill to divide corporations into those making more or less than $10,000 income might have partially reduced this inequity in so far as it can be said that the stockholders in small corporations are more apt to be in the lower surtax brackets. The specific credit of section 14 (c) of the final bill tends in the same direction. The inequality as to poor and rich stockholders of the *same* corporation remains. A truly equitable system can probably be achieved only by taxing to the corporation an amount equal to the sum of the taxes which would have been paid by the several stockholders on the corporate earnings had these been distributed and holding such undistributed amounts tax free in the case of any subsequent distribution. A method suggested by Dr. Adams as theoretically sound, but rejected by him as economically impractical, is to "put a tentative surtax on corporations high enough to make it to the interest of the corporation and its stockholders to elect 'voluntarily' to pay, in lieu of this tentative surtax, the ordinary or regular surtaxes on the stockholders' respective shares in the undistributed profits of the corporation. In short, make it profitable for the corporation and its stockholders to elect to pay taxes like the partnership and its members."

[46] Interview with the President, N. Y. TIMES, p. 1:4 (March 3, 1936). One basis for this argument seems to be the conviction that corporations, having obtained the stockholders' money, are proceeding to play fast and loose with it in disregard of stockholders' interests and should be forced to disgorge the full return on the investment. Whether such distributions should be sought for economic reasons is considered in the text, infra.

[47] See discussion of a related plan, referred to in note 13, supra, by J. F. Zoller, PROC. SECOND NAT. IND. TAX CONF. 196 (Oct. 1920), as a direct aid to small business. A diametrically opposed position has been taken by many witnesses. See text, infra.

[48] See the remarks of the President in discussing the question of corporate taxation in Message to Congress, June 19, 1935, in which he stresses the importance of small business to the national economy, adding that "Size begets

ed by the President that this tax will be of economic benefit in increasing the velocity of monetary circulation.[49]

Economic Questions Raised by the Surtax on Undistributed Corporate Profits

Most witnesses for or against the bill assumed that they knew how it would operate on the policies of companies affected. In general it was taken for granted that larger dividend distributions would result. The clearest fact emerging from testimony taken is that though the bill may be expected with reasonable certainty to raise revenue, since either the corporation or the stockholder will pay additional taxes, it cannot be predicated with any certainty that corporations will or will not distribute more dividends. If the rate of retention in the past has been dictated by prudence rather than by the desire of particular stockholders to avoid the surtax, as may be thought to have been true in the majority of cases,[50] then, it is reasonable to suppose that prudence will require the retention of this same amount *plus* enough to cover the additional tax. Dividends will to this extent be smaller rather than larger. Even if increased dividends are declared by boards of directors which are controlled by large stockholders, the increase will be limited by the fact that stockholders are not likely to urge the payment of any dividends which would have the ef-

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monopoly." 79 Cong. Rec. 9713 (1935). The storm of criticism leveled at this message seems justified in so far as it attacked the implication that corporate bigness is per se detrimental. From the economic standpoint, the bigger the corporation, assuming a corresponding increase in efficiency and consequent lower cost of production per unit, the greater benefit to the nation as a whole. This does not deny that regulation may be necessary, but it is highly questionable whether such regulation should be through taxation based upon size.

[49] Note 46, supra. What this means is not at all clear. It was apparently thrown out casually in answer to a reporter's question. Presumably it has a relation to the prevalent concept that a falling price level is a bad thing and that increased velocity of circulation will produce a rising level of prices. That a falling price level is not necessarily undesirable, see Durbin, Purchasing Power and Trade Depression 71-78, 173, 175-176 (1933); Moulton, Income and Economic Progress 117-141. Criticizing the President's reasoning, see Editorial, "Money Velocity," N. Y. Times, p. 14:1 (March 28, 1936).

[50] No satisfactory evidence has been offered as to the extent of *deliberate* tax evasion by means of restraining distribution of dividends. The most that can be said is that there has been some such evasion, that the mere existence of section 102 has probably forestalled such evasion in some cases, and that the number of actual cases under section 102 has been small.

fect of impairing the very safety of their capital investment. Where such control of directors is lacking, it is difficult to see why past policies of dividend declaration should be materially changed except as suggested above.

The argument urged by the opponents of the act that it will be impossible under the new tax to accumulate surplus does not carry much weight. The House bill was drawn so as to allow the addition of at least 30 per cent of earnings to surplus without subjecting the corporation to a greater tax than had been paid under the then existing act.[51] The corporation could, by refraining from distribution, add considerably more than this to surplus. Under the act as finally adopted, a corporation retaining forty per cent of a $100,000 income will pay approximately eighteen and one-half per cent on its total net income. If these several conclusions are correct, much of the argument that the national corporate financial structure will be undermined by the bill is irrelevant. The conclusions apply to the healthy corporations. The effect of the act in certain pathological cases will be referred to subsequently.

It should be noted that statements of Treasury officials in defense of the new act lay stress primarily upon the amount of liquid assets held by the corporations of the country.[52] This position shows at least one fundamental confusion in the minds of the supporters of the bill. It becomes clear from reading the testimony taken that what is really objected to is the accumulation by corporations of large amounts of *liquid* assets in the form of cash, bank deposits and security investments.[53] The act, however, does not aim at these items alone but at additions to surplus generally. This is highly important because the addition to liquid assets resulting from the earnings of a year's operations will almost invariably be a totally different figure from the figure for earnings transferred to surplus. Additions to surplus may be $1,000,000, while the increase in liquid assets may be nil or even a minus quantity.[54]

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[51] Testimony of G. T. Helvering, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 23-24 (1936).

[52] See text, infra, at notes 58 and 66.

[53] Whether such accumulations are detrimental has been to some extent considered in the text, supra.

[54] Testimony of W. H. Mooney, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 638-639 (1936), G. E. Holloway, ibid., pp. 694-695; testimony of R. G. Berry, H. Hearing on H. R. 12395, 74th Cong., 2d sess. pp. 844-845 (1936).

To tax additions to surplus as though they were liquid means that the corporation whose liquid capital has not been increased by earnings must borrow, draw down its cash reserves, if any, or liquidate some part of its plant, equipment, or inventory to pay dividends to avoid taxes, or it must pay taxes because of failure to pay sufficient dividends.[55] There does not seem to be any evidence that corporation surpluses, liquid or otherwise, are per se detrimental. In fact, the Treasury has recognized that to some extent at least they are desirable.[56] That liquid assets largely in excess of the needs of the business are undesirable is a possible though not proven economic hypothesis. Assuming its proof, however, if the aim is to do away with these accumulations, the method is not well adapted to the end, including as it does in its penalty, *all* additions to surplus from earnings.

It is contended by the Government[57] that such a bill will be a check on the severity of booms and depressions in that it will (a) be a brake on excessive expansion, (b) lessen speculation, and (c) maintain purchasing power because money will be distributed to stockholders. The arguments, it should be noted, are based upon a tacit assumption that distribution to stockholders will probably occur. While it is true that cash holdings of corporations increased 5.6 billions between 1926 and 1929,[58] we cannot ignore the conclusions of the Brookings Institution that between 1900 and 1930 the unutilized margin of productive capacity in the United States *did not increase* in manufacturing, electric power utilities, agriculture, mining (except for the dislocation of the war), and probably also construction and merchandising.[59] Only in transportation are

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[55] Testimony of N. Sargent, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 660-664 (1936). See the same criticism regarding depletion of working capital, 1 REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 70th Con., 1st sess., p. 54 (1927).

[56] Testimony of G. T. Helvering, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 23-24 (1936).

[57] Testimony of H. Oliphant, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 927 (1936).

[58] Ibid.

[59] NOURSE, AMERICA'S CAPACITY TO PRODUCE 421 ff. (1934). At p. 425, it is said, "Equipment was being maintained at a rate entirely suitable to the indefinite continuance of operations at the 1929 rate of activity. There was an unutilized margin which, in the perspective of the past, would appear to be about normal."

there indications of an increasing unproductive margin. A subsequent volume of the Brookings studies concludes that while *individual* savings increased in relation to the aggregate national income, *corporate savings,* through additions to surplus, though increasing in amount of dollars saved, did not constitute "any larger percentage of the national income in 1929 than they did 20 years earlier."[60] In the light of such findings, the argument that our productive capacity had been over expanded and that this was due to the accumulation of corporate surpluses is of doubtful validity.

That corporation cash reserves did contribute in some degree to the rise of stock prices through the device of brokers' loans is doubtless true, but any argument that these were solely or even primarily responsible must meet the fact that in 1929, for example, in addition to corporate savings of between two and three billions there were *individual* savings of some thirteen billion dollars available to force security prices upward. It is noteworthy that corporate financing, to increase plant and production through new stock issues, had, for the six years prior to 1929, stood at approximately five billion dollars annually and had in every year been less, by several billions of dollars, than the amount of savings flowing into the market to purchase securities.[61] The normal result of limited supply and heavy demand seems to have occurred as savings in excess of the amount required for the financing of new production were used to bid up stocks. It should also be remembered that corporate earnings in 1928 and 1929 were of a size to justify, at least in some part, the prices for equities then prevailing. The Treasury's argument as to the effect of corporate reserves upon speculation may therefore be easily overemphasized.

The view that earnings, retained by the corporation and appearing on its books as an addition to surplus at the end of the year, are withdrawn from the industrial economy and represent lost or delayed purchasing power is also doubtful economic theory. In the first place, a large part of such surplus is spent in production and in maintaining plant and equipment. To this extent it flows on down to the worker and in-

[60] LEVEN, MOULTON and WARBURTON, AMERICA'S CAPACITY TO CONSUME 100-108, 110 (1934).

[61] MOULTON, THE FORMATION OF CAPITAL 146-154 (1935).

creases purchasing power at a rate at least as great as if the same amount were distributed to stockholders who are primarily in a higher income class and therefore more likely to use their money in savings and investment than are wage earners. Nor can it be said that such portion of annual earnings as consists of cash and bank deposits is stagnant. Some part of these funds performs the very necessary economic function of a coverage for contingencies and immediate expenses. The part not so required gives support as bank deposits to the expansion of commercial loans.[62] The economic advantages urged in favor of the bill, therefore, do not appear to stand close inspection.

It has been argued to the contrary that accumulated reserves are available to prevent depressions from being so severe in that they allow the maintenance of some dividends and of employment which would not otherwise exist.[63] To this contention there is some merit if it be assumed that the undistributed profits tax will prevent the accumulation of surplus. As has been previously suggested, this will not necessarily be the result of the tax. If this assumption be made, however, that national corporate structure may suffer to the extent that smaller corporate surpluses might mean more quickly impaired capital in time of depression with a consequent restriction on dividends, and perhaps, a lessened ability to obtain credit. In recent years the surpluses of many firms have been substantially reduced. In some cases capital has been impaired. That the undistributed profits of the last boom were absorbed and existing surpluses heavily trenched upon by corporations as a whole is indicated in the fact that total dividends paid between 1921 and 1933, amounting to $50,700,000,000, exceed net earnings for that period by nearly 10 billion dollars.[64] It must nevertheless be kept in mind that corporate surplus may be almost entirely represented by plant and equipment rather than cash, and the mere fact that a cor-

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[62] MOULTON, THE FORMATION OF CAPITAL 107 (1935), stressing the effect of lending by the commercial banks in allowing the continuance over long periods of simultaneous consumption and saving.

[63] Testimony of N. Sargent, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 666 (1936). Also, Seligman, "Tax on Surpluses Called a Danger," N. Y. TIMES, § 3, p. 1:1 (March 22, 1936).

[64] TREASURY STATISTICS OF CORPORATE INCOME, tabulated in BUL. NAT. CITY BANK 56 (April, 1936).

poration has piled up on its books a large surplus item does not mean that it will have liquid resources on which to draw in time of depression. It may even be forced into receivership with a surplus still recorded on its books. Thus, while a surplus in some instances may prevent the actual impairment of capital, the existence of a surplus on a corporation's books is no guarantee that the corporation will survive even a mild depression. It cannot be fairly said by opponents of the act that without a surplus a corporation must die in time of depression, leaving it to be implied that with a surplus it would survive. Nor can it be argued that the existence of a surplus means necessarily greater employment in depressed periods. A priori it would appear that corporations with liquid funds would husband them very carefully in time of depression. Statistically this seems correct. The Treasury figures show that disbursements in dividends did not exceed net receipts during the depression[65] and that *liquid* capital was not drawn down to maintain employment or pay dividends.[66] We may conclude that a large surplus is not indispensable to a corporation's continued existence even in time of depression, that the liquid part of corporate surpluses has not been used to maintain dividends or employment in depressed periods, but that the presence of a surplus may have had an effect on dividend payments in the case of corporations which could not otherwise have paid dividends because of *legal,* rather than financial, restrictions on the payment of dividends when capital is impaired. In short, neither the arguments set out by the Treasury in favor of the bill as a force in mitigating the sever-

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[65] Testimony of G. C. Haas, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 58-61 (1936).

[66] The figures cited show cash and investments of all non-financial corporations in 1929 at 32.7 billion dollars and in 1933 at 33.5 billion dollars. Per contra, the Department of Commerce in 14 SURVEY OF CURRENT BUSINESS 17 (Feb., 1934), says of 1923-1932:

"In large areas of the economic system, enterprises paid out in wages, dividends, interest, rents and the like, more dollars than they received for the goods and services which they produced. Such withdrawals represent a draft upon previously accumulated surplus and assets which are possibly derived in part from the creation of new debt obligations, which would be in effect a withdrawal currently of anticipated future income. For corporations alone the excess paid out amount to about 7 billion dollars; this was almost three times the net dividends paid and the major portion must, therefore, have gone to sustain other payments, such as salaries and wages and interest."

ity of depressions nor the arguments of opponents of the bill as to the importance of having large surplus cushions to soften the depressions's pinch carry very great conviction. The arguments have been pressed far beyond their merits on both sides.

Finally much has been said on the question of hardship on the small corporation.[67] Will the act injure the ability of the small corporation to finance its needs and so injure its owners? In answering this question, it should be remembered that financing for the small corporation has always been a somewhat difficult task. It must be agreed that for the small corporation to attempt to finance itself through the security markets is out of the question both because of the expense involved and because of the fact that a market could be established only with difficulty for securities of small companies with an essentially local reputation.[68] On the other hand, it is urged by the Treasury that the difficulty of obtaining finances for small corporations will not be increased even though the present act should force distribution of earnings and even though resort cannot be had to the security markets. It is contended that the one exception will be the case where stockholders, receiving dividends, refuse to reinvest such funds as are needed by the company and the argument is fairly cogent that since the stockholders are owners of the company, if they refuse to reinvest, it can be no cause for complaint by anyone. The question of business expansion is one which the owners of the business alone may properly determine. In addition it is said that the small corporation does not need the security markets in any event, but will finance its needs, as in the past, by personal and informal negotiation with its stockholders.[69] The argument is further adduced that since the principal stockholders of small corporations are generally in lower income brackets than the principal stockholders of large corporations, the former will pay less income tax on the divi-

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[67] Testimony of R. L. Sweet, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 165 (1936); of H. B. Fernald, ibid., p. 249; of E. C. Alvord, ibid, p. 286; of G. O. May, ibid., p. 544; and of N. Sargent, ibid., p. 668.

[68] As to the extent of reliance by small companies on the security market for financing, see U. S. Dept. of Commerce Business Advisory Council, Survey of Reports of Credit and Capital Difficulties Submitted by Small Manufacturers, pp. 1-4 (April 15, 1935).

[69] Testimony of H. Oliphant, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 917-918 (1936).

dends received and, relative to the amounts distributed, will have more to reinvest.[70] Whatever these latter points are worth, it seems true that an inability to get the owners of a business to put their earnings back into it cannot be spoken of as "hardship on the corporation" unless the doubtful position is taken that stockholders, once in, have an obligation to play ball, whether they like the game or not, for the benefit of the officers and other stockholders.

One objection, however, may be made to the government's position regarding the way in which corporations should refinance. which applies to both large and small corporations. If the act leads to the retention by corporations of the same amounts as have been withheld from dividends in the past, plus enough to cover the new tax, corporate financing will continue as in the past to come largely from additions to surplus. Upon the alternative assumption, however, that the act will result in greater dividend distributions, the sale of additional stocks and bonds as a means of financing corporate needs may decrease the stability of the corporate structure as a whole. The method of financing by additions to surplus does not result in increased indebtedness, as must be true if bonds or notes are issued. Nor do such additions to surplus result in an increased capitalization, such as results if stock is sold rather than bonds. During depression a large b o n d e d indebtedness has been found to be a stone around the neck of many corporations, necessitating reorganization. Likewise a high capitalization tends to result in impaired capital in times of stress and, because of the restrictions in most state corporation acts on payment of dividends when capital is impaired, may also have an unsettling effect on the business structure."

A further capable discussion of the problem is found in "Taxes" (a tax magazine), issue of September 19, 1939, at pages 516-517, by William J. Shultz of the School of Civic Ad-

[70] Testimony of G. C. Haas, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 36-37 (1936).

ministration of the College of the City of New York, which we also quote:

TAXES—The Tax Magazine, September, 1939.

"The Undistributed Profits Tax

Taxation of undistributed corporate profits was proposed by the Administration in 1936, and reluctantly accepted by Congress. President Roosevelt intended that a levy on undistributed profits, at substantial rates, should be the only tax on corporations; Congress balked at such a far-reaching application of an untried principle, and enacted the tax as a supplementary levy, superimposed on the pre-existing corporate income, excess profits, and capital stock taxes. The rate of the undistributed profits tax, under the 1936 act, ranged from 7 per cent to 27 per cent according to the fraction of the corporation's income not distributed as dividends during the year.

Directly and indirectly, this tax was intended to be a revenue producer. Some tax would be paid by corporations which held back part of their year's earnings. And to the extent that the tax forced larger dividend payments than would otherwise have occurred, it would increase the personal incomes of the dividend receivers and so make them liable to larger personal income taxes. But an expansion of federal revenue was only one of the virtues of this tax to President Roosevelt and his advisers, and possibly only a minor one; much more important to their view was the effect this tax would have upon the rate and character of the saving process and upon the democratization of corporate management.

The ideas of 'excess savings' and 'improperly invested savings' as causative factors of business fluctuation were forced upon popular attention by a number of writers during the 1930's. Corporate savings were denounced as a particularly vicious type of saving; they contributed to 'excess' accumulations of savings, and their investment was likely to produce economically injurious effects.[1] Why not cut the

[1] See Rexford G. Tugwell, *The Battle for Democracy* (Columbia University Press, New York, 1935), Chapter XXI; David Cushman Coyle, *Brass Tacks* (National Home Library Foundation, Washington, 1935), p. 22.

taproot of the evil, argued these writers, by penalizing corporate saving? Individual recipients of the extra dividends distributed because of the tax will save only part of these 'windfall' receipts, whereas the corporations would have saved all; thereby 'excess' saving will be reduced. And to the extent that the recipients of these extra dividends do invest them, they will do so more wisely than the corporate management, since they will survey the entire investment field in determining the placement of their funds, while corporate managements can have only a limited investment vision.

President Roosevelt's comments on the undistributed profits tax in 1936 and 1938 indicate that he was considerably influenced by this line of reasoning. Even more was he won to the tax by the argument that it would promote democracy in corporate management. The power of corporate boards—particularly the boards of large corporations whose shares are widely held—over the disposition of undistributed profits is, for all practical purposes, absolute. They can use them to pay off bank loans, accumulate 'dead' balances, enlarge their properties and operations, or buy into control of other corporations, with no other accountability to the stockholders than the annual farce of the proxy-dominated election. But if a tax law imposes a substantial penalty upon the accumulation of profits, this oligarchic dominance of corporate finance policy is weakened, if not ended. A corporate board without accumulated profits at its command must submit its plans for expansion, for new investment, to the judgment of the corporation's shareholders and of the general investment market. Perhaps the shareholders will agree with the management, and will reinvest their extra dividends in new shares. Perhaps the market will ratify the decision by taking up a new issue on favorable terms. The purposes of the undistributed profits tax are nonetheless served.

Criticism of the undistributed profits tax was immediate, violent, and based upon considerable reason. Opponents of the tax flatly denounced the whole theory of 'excess' savings—and while their denunciation went too far in that it denied any element of validity to the theory, still they were on sound ground since the proponents of the theory cer-

tainly had not established it sufficiently firmly to serve as foundation for taxes specifically intended to *reduce* savings. These critics pointed out a regulatory effect overlooked by champions of the tax—that accumulation of profits was more common to small but growing enterprises that did not have ready access to the general investment market than to large established corporations, so that the tax discriminated against the progressive small company.

The 1936 statute was badly drafted and worked unnecessary inconvenience. A concerted drive in 1938 to wipe out the undistributed profits tax failed, but the tax was reduced to a modest 2½ per cent credit for distributed dividends allowed against corporation income tax liability. Supporters of the tax saw in the 2½ per cent distributed profits credit a mere shadow of an effective undistributed profits tax. However, the tax was repealed by the Revenue Act of 1939."

Notwithstanding all of the doubts as to the economic problems involved in the statute (concerning which we have trespassed upon the court's time to indicate) the legal problems do not seem to be in such confusion.

There are certain basic legal principles upon which there cannot be disagreement.

First:

> "* * * Corporations may accumulate what profits they please, so long as they *do not do so* to defeat the fiscal policies of the United States. Their business whose regulation *is wholly for* the States, does not include the manipulation of dividends to avoid taxes: by definition that has nothing to do with the normal management of their affairs. Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose."

See:

United Business Corporation v. *Commissioner*, 62 F. (2d) 754;

Certiorari denied, Oct. 9, 1933, 78 L. ed. 552.

Upon a first reading of the foregoing quoted portion of Judge Hand's opinion, one might assume that its context relates to the question here.

In fact what was there said, had solely to do with a *penalty* statute (Sec. 220 Rev. Act of 1921) enacted for the punishment of the creation of a device to avoid the imposition of an otherwise valid *income* tax. That provision of the law in substance *remained in effect during 1936* (as Sec. 102 of the Revenue Act of 1936) and did not (in *United Business Corporation* v. *Commissioner, supra)* have to do with the question of the power of Congress *to pass* that Act.

What Judge Hand was considering might be likened to the penalty for failure to file an income tax return due on March 15th in any year. That penalty is fixed as punishment for an attempt to defeat by obstruction a fiscal policy of the United States.

The imposition of a penalty for *failure to file* a return due, does not determine the right to deductions upon the return when filed, or the constitutionality of a tax upon the *retention* in accumulated surplus, of undistributed profits earned in such year.

In *Willcuts* v. *Milton Dairy Company,* 275 U. S. 215, 72 L. ed. 248, Mr. Justice Sanford in distinguishing "surplus" and "undistributed profits" laid down certain basic definitions which are of *importance* in the consideration of the validity of an income tax upon "undistributed profits."

We quote from that opinion:

> "We think that clause (3) relating to 'surplus and undivided profits' was correctly interpreted by art. 838 of the Treasury Regulations. *Both these terms as commonly employed in corporate accounting denote an excess in the aggregate value of all the assets of a corporation over the sum of all its liabilities, including capital stock.* See Edwards v. Douglas, 269 U. S. 204, 214, 70 L. ed. 235, 240, 46 Sup. Ct. Rep. 85;

Insurance Co. of N. A. v. McCoach, (D. C.) 218 Fed. 905, 908. Aside from the fact that a surplus may not only be 'earned,' as where it is derived from undistributed profits, but 'paid in,' as where the stock is issued at a price above par, the distinction between these terms, as commonly employed, is that the term 'surplus' describes such part of the excess in the value of the corporate assets as is treated by the corporation as part of its permanent capital, usually carried on the books in a separate 'surplus account;' while the term 'undivided profits' designates such part of the excess as consists of profits 'which have neither been distributed as dividends nor carried to surplus account.' Edwards v. Douglas, supra, 214. But it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus,' that the net assets of the corporation exceed the capital stock. *Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'*

"We cannot doubt that this term was used in clause (3) with its ordinary meaning, nor agree with the view of the circuit court of appeals that the arbitrary definition given by the act to the term 'invested capital,' not equivalent to that of the ordinary invested capital of commerce, indicates that the words 'surplus and undivided profits' were not used with their ordinary meaning as conditioned by an excess of assets. We do not think Congress intended that a corporation whose capital was impaired *should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as 'undivided profits.'* This would not only give the term 'undivided profits' a meaning entirely at variance with ordinary usage—making it merely equivalent to any earned profits remaining in the business—but would grant the privilege of twice disregarding the impairment of capital, that is, once in computing the paid-in capital, which under the express terms of the act was to be taken at the full cash or money value at the time of payment, and again in

computing the 'undivided profits.' This term is entirely inapt to express such a purpose." (Italics supplied.)

Consistency is a rare jewel, and "undistributed profits" and "surplus" remain and must be defined in terms of the same quotient, whether for "deduction" purposes as in *Willcuts* v. *Milton Dairy Co., supra,* or for "tax" purposes as in this case.

See:

McLaughlin v. *Baker, Hamilton & Pacific Co.,* 31 F. (2d) 546.

One other important decision relates to the interpretation made by Judge Hand in *United Business Corporation* v. *Commissioner, supra, viz.,*

Helvering v. *Nat. Grocery Co.,* 304 U. S. 282, 82 L. ed. 1346.

This much cited, but not carefully analyzed, decision is authority *only* for the position that a corporation *owned beneficially entirely* by a *single* stockholder (Henry Kohl), may be *penalized* for the adoption of a *device* such as that employed to enable such corporation to permit

"* * * gains and profits to accumulate instead of being divided or distributed.",

for the *purpose of preventing the imposition* of surtaxes upon such shareholder (or shareholders, if more than one) employing such device.

The important thing to remember in connection with this decision is that (headnote 1, page 286),

"The National Grocery Company *concedes* that Sec. 104 (which remained in effect as Sec. 102 in the Revenue Act of 1936) is constitutional *as applied* to a corporation *organized for the purpose of preventing* the imposition of surtaxes on its shareholders, but *urges* five reasons why it should be held void as applied to a

> *legitimate* business corporation which is '*availed of*' for the forbidden purpose. None of these reasons is sound."

Under this (as well as all other prior decisions) the statutes being considered had to do with *penalties* against the creation of an obstruction to the fiscal policy of the United States (and that fact had to be so found in each instance), whereas, the law here attacked, has to do with a tax levied without regard to evasion of fiscal policy or the organization of the offending corporation for such wrongful purpose.

Furthermore, the *second* of the *five* contentions by the Grocery Company, was the only one made that bears any relation to the present consideration.

For the convenience of the court we quote the *second* contention:

> [288]
>
> "*2.* It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually, all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxed to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon,* Nos. 144 and 145, decided May 16, 1938 (304 U. S. 271, *ante* 1337, 58 Sup. Ct. 926).
>
> "Kohl, the sole owner of the business, could not, by conducting it as a corporation prevent Congress if it chose to do so, from *laying on him individually the tax* on the year's profits.
>
> "If it preferred, Congress could lay the tax upon the corporation as was done by Sec. 104. The *penal nature* of the imposition does not prevent its being

valid as the tax was otherwise permissible under the Constitution.

Compare *Helvering* v. *Mitchell*, 303 U. S. 391, *ante* 917, 58 Sup. Ct. 630."

Section 104 of the Revenue Act of (May 29) 1928, Chap. 852, 45 Stat. at Large 791, 26 U. S. C. A., Sec. 104, note, provides:

> "*(a)* If any corporation, however created or organized, is *formed or availed of for the purpose* of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected and paid, for each taxable year *upon the net income* of such corporation a *tax* equal to 50 per centum of the *amount* thereof, which shall be in addition to the tax imposed by Sec. 13."

It was the constitutionality of this section that *was conceded* by the Grocery Company. Its defense according to Mr. Justice Brandeis was that,

> "it should be held void as applied to a *legitimate* business corporation which is 'availed of' for the forbidden purpose."

Whether Mr. Justice Brandeis' opinion is based upon the conclusion that the Grocery Company was not a "legitimate business corporation" or was merely a corporation engaged in "a fraudulent effort to defeat the fiscal policy of the United States" (discussed by Judge Hand in *United Business Corporation* v. *Commissioner, supra)* is not clear from the opinion but is of passing importance.

The citation of *Helvering* v. *Mitchell*, 303 U. S. 391 (ante 917), 58 Sup. Ct. Rep. 630, 82 L. ed. 917, by Mr. Justice Brandeis, as authority for overruling the Grocery Company's *second contention*, clearly shows that *fraud* and attendant penalty was the basis for the rule.

There remains a vast difference between a *penalty for fraud* and a *tax* for the *failure to distribute* earnings. The latter admittedly may be levied by Congress, but not as an *income tax.*

Of important consideration in connection with the petition for the writ in this case, is the *concession* of constitutionality upon the part of the petitioner (whose complaint involves but a small amount of tax, *viz.*, approximately $1700.00) in its failure to challenge the invalidity of the act save in the respect of its sole contention as to its charter from the state constituting a contract to be given effect within the exemption provisions of the statute. Such concession by the petitioner should not be received as a concession of constitutionality upon the part of every taxpaying corporation affected by the complained of statute.

The unfortunate consequence of such conclusion is doubly disastrous (where as here) tax paying corporations having large tax liability, and believing the law to be invalid (by reason of mere delay in securing an adjudication upon the constitutional questions in their respective circuits) are unable to have had their objections to the constitutionality of the act ruled upon before an order will be entered in this court in this cause which *may preclude* these taxpayers from thereafter having such constitutional objections *ruled upon at all.*

The denial of the writ upon the skeleton record in this cause and the sole question presented thereon will foreclose the constitutional objections to the act which are over and above the objection urged by petitioner, and these taxpayers are therefore greatly concerned that such constitutional objections shall be brought to the attention of this Honorable Court, and therefore respectfully ask that this brief *amici curiae* be received and considered in support of the allowance of a writ to review the whole of the constitutional questions involved.

Second:

The Sixteenth Amendment did not *extend* the Federal taxing power to *new subjects*, but merely removed the necessity for apportionment of taxes laid on income.

A tax laid on *income* which has become *accumulated capital*, would be *invalid* unless apportioned and it must be conceded that income in time *becomes* accumulated property.

Each of the income tax measures adopted since 1862 has applied to income *earned during* the entire calendar year. All of them have been sustained against this exception and all other objections except the Act of 1894 which was held unconstitutional in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 15 Sup. Ct. 912 (1895), 39 Law. ed. 1108, *as being a direct tax unapportioned.*

It is evident that the complained of tax is a *direct* tax upon property and must be *apportioned* for the identical reasons given by the Supreme Court in the Pollock case, supra; as a result of which this Act *must be* held to be unconstitutional in so far as it proposes to place a *so-called income tax* upon *property accumulations.*

The foundation for the *tax* upon the *undistributed corporate surplus* is found in Mr. Justice Brandeis' dissenting opinion in Eisner v. Macomber, supra, and its *fruition* represents an effort to accomplish by *legislative fiat* what the majority of the Supreme Court has for more than twenty years refused to approve, or has been unwilling to accept, as constitutional.

The entire purpose of the legislation represents a startling departure from constitutional land marks, and while appearing innocent enough in so far as *basic* rights are concerned will not withstand scrutiny in that respect.

The warning which is carried by this legislation is that if Congress may for such purpose regulate *any* conduct by the use of a revenue measure, then it may for many purposes *reg-*

ulate all conduct. Again, if Congress may by the use of a revenue measure say to the corporation what shall be done with its earnings, after an income tax has been once paid thereon and such earnings thereby *cleared* for *disposition* as ownership shall dictate, just as certainly may Congress determine by the employment of other *revenue* measures how much of the individual's *earnings* shall go into the *"conduit of income in the interest of velocity* of *monetary circulation,"* and to what extent departures from such standard of conduct shall be taxed.

Is it not apparent that such legislation violates every principle of constitutional government as that term has always been interpreted in this country?

It has been by such invasions of basic liberties (subtly) taken in exchange for temporary expediency that the collapse of free governments has been brought about.

The dollars taken from the offending corporation are but as trash when compared to the priceless jewel of constitutional government which is tarnished by this legislation.

If it be desirable, in the interest of the public welfare, to say the corporation *shall not accumulate* a surplus *let it be so written* upon the rock of constitutional guaranties but never *upon shifting sands in the base alloy of hypocrisy.*

The repeal of the offensive legislation by Congress while evidencing public sentiment does not meet the challenge.

In the courts, which have always been the Anglo-Saxon bulwark of human liberty, let it continue to be said in language that may be understood by all, that *revenue legislation* with an *ulterior purpose* has no place in a government of free people.

Hammer v. *Dagenhart,* 247 U. S. 251, 62 Law. ed. 1101, 3 A. L. R. 649, 38 Sup. Ct. Rep. 529, Ann. Cas. 1918E, 724.

Bailey v. *Drexel Furniture Co.,* 259 U. S. 20, 66 Law. ed. 817, 42 Sup. Ct. Rep. 449, 21 A. L. R. 1432.

Linder v. *U. S.,* 268 U. S. 5, 17, 69 Law. ed. 819, 823, 45 Sup. Ct. R. 446.

We cannot more aptly express our position than to quote from Chief Justice Taft in the *Drexel Furniture Company* case, *supra:*

> "* * * The good sought in unconstitutional legislation is an insidious feature because it leads citizens and legislators of good purpose to promote it without thought of the serious breach it will make in the ark of our covenant, or the harm which will come from breaking down recognized standards.
>
> "In the maintenance of local self-government, on the one hand, and the national power, on the other, our country has been able to endure and prosper for near a century and a half.
>
> "* * * in the act before us, the *presumption of validity* cannot prevail, because the proof of the contrary is found on the very face of its provisions. Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the 10th Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states."

(c) The complained of provisions of the Revenue Act of 1936 are unconstitutional and invalid in that the Act discriminates against corporations (such as the Utah Hotel Company) with no "earnings or profits accumulated after February 28, 1913" in that such corporations are required to pay the tax unless a dividend (as defined by the Act, which we say is contrary to the meaning of that term within the limitations of the Sixteenth Amendment, as defined in Eisner v. Mac-

omber, supra), be made to stockholders which (under such circumstances) could but be solely a return of capital.

The *dividends paid credit* (see Sec. 27, Revenue Act of 1936) is:

(a) the amount of "dividends" paid,

or,

(b) that part of a distribution in liquidation of the company which is properly chargeable to the *earnings or profits accumulated after February* 28, 1913.

Dividends as used in Section 27, are defined by Section 115:

"(a) *Definition of Dividend.*—The term 'dividend' when used in this title means any *distribution* made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) *out of the earnings or profits of the taxable year* (computed as of the close of the taxable year), *without regard to the amount of the earnings and profits at the time the distribution was made.*

"(b) *Source of Distribtuions.*—For the purposes of this Act every distribution is made out of *earnings* or *profits* to the extent thereof, and from the most recently accumulated earnings or profits."

Sec. 115 (a) (2), *supra,* was new in the 1936 Act, and a very substantial extension of the definition of the term "dividend" contained in all prior acts. That new definition in so far as it includes in income a distribution made to stockholders by a corporation which had no accumulated surplus, income, earnings or profits, is unconstitutional, for the reason that such distributions cannot be taxed as "income", as that term was used in the Sixteenth Amendment and defined in *Eisner* v. *Macomber, supra.*

Under such circumstances, any distribution by a corporation with an "operating deficit", or at best a "surplus by appraisal" only, (as in the *Northwest Steel Rolling Mills* case) *could be nothing more* than a return to its stockholders of their proportionate interest in the corporation's capital. Such distribution does not become income, as defined in *Eisner* v. *Macomber, supra,* or in the *United States* v. *Safety Car Heating Company* case, *supra,* as well as in many other decisions by the Supreme Court of the United States.

In this connection, and for interpretative purposes, the Senate Finance Committee Report No. 2156, 74th Cong. 2d Sess., pp. 18, 19, should be quoted. It reads:

> "Section 115 (a). *Dividends Out of Current Earnings.* In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary."

As to a *dividend paid credit* for surtax purposes, however, Sec. 27(h) provides:

> "If any part of a distribution * * * is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made no *dividends paid credit* shall be allowed with respect to such part."

That is to say, that unless *any distribution* made *be reported*

by the recipient stockholder as income, the corporation *must pay the surtax.*

As to distributions in liquidation, Sec. 27(f) provides:

> "Distribution in Liquidation.—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purpose of computing the dividends paid credit under this section, be treated as a taxable dividend paid."

It is obvious, therefore, that such corporations as Northwest Steel Rolling Mills, the Utah Hotel Company, the Crane-Johnson Company, as well as all other corporations, *without accumulated profits or earnings* after February 28, 1913, *could find no relief from the tax by liquidating.*

The Commissioner anticipated an adverse ruling by the courts upon the situation to which we direct attention, and has given a taxpayer something Congress did not authorize or the language employed contemplate.

First. Read Section 27(f) of the Act, and then examine the following quoted ruling; viz., I. T. 3067-XVI-16-8647:

> "REVENUE ACT OF 1936
>
> The M Corporation which was completely liquidated in 1936, is entitled to a dividends paid credit under section 27(f) of the Revenue Act of 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beginning of the taxable year in excess of the earnings and profits for that year.
>
> Advice is requested whether the M Corporation upon its liquidation in the year 1936 is entitled to a dividends paid credit under section 27(f) of the Revenue Act of 1936 where its operating deficit at the beginning of the year 1936 exceeded its earnings and profits for that year to the date of liquidation. It is

stated that in the liquidation of the M Corporation in the year 1936 all assets, including earnings for that year, were distributed to shareholders, that no part of the assets was transferred to another corporation, and that the M Corporation discontinued operations in that year.

Section 27(f) of the Revenue Act of 1936 provides that:

> "'(f) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.'

Section 14 of the Act imposes a surtax on *undistributed* profits. That surtax is measured by the '*undistributed* net income' of the corporation. Congress contemplated in the enactment of the statute an accumulation of current profits retained in fact by the corporation, a current accumulation withheld by the corporation from distribution to shareholders. It is obvious that in the case of a complete liquidation of a corporation no income remains undistributed and, therefore, there is nothing to which the undistributed profits tax is applicable. In this situation it is immaterial whether the prescribed distribution takes the form of an ordinary dividend or a distribution in liquidation.

In view of the above, it is held that in the case of the complete liquidation of the M Corporation the corporation is entitled to a dividends paid credit for the year 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beinning of the taxable year in excess of the earnings and profits for that year."

The effect of this ruling is to say, that in the case of a *dissolving* corporation the quoted provisions, supra, of section 27(f) of the Act will be ignored *by the Commissioner* and the

corporation released of tax liability, quite evidently upon the theory that the corporation in *going out of business* was doing all that it could possibly do to comply with the *economic* theory back of the passage of the law.

The Treasury Department in Internal Revenue Bulletin 1937-2, page 134, General Counsels Memoranda, 18602, XVI-32-8862, page 2, further anticipating the ridiculous position that would result from the assertion that Section 27(f)—limited *dividend paid credit* to the total of earnings or profits accumulated after February 28, 1913, ruled that:

> "A is entitled to a *dividend paid credit regardless* of whether the distributions are taxable in the hands of the shareholder." (Citing: I. T. 3067 XVI-16-8647.)

This ruling is in the face of the plain language of 27(h) (quoted supra) as follows:

> "If any part of a distribution * * * is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made no *dividends paid credit* shall be allowed with respect to such part."

That attached hereto as Appendix Exhibit "A" is a certified copy of the undetermined complaint in the suit of the *Utah Hotel Company, a corporation,* v. *Ira N. Hinckley, Collector of Internal Revenue,* U. S. District Court for the District of Utah, Civil No. 84 (in which answer has just been filed by the Government), which complaint sets forth a concrete situation such as complained of in this subdivision of the foregoing brief.

That also attached hereto as Appendix Exhibit "B" is a certified copy of the undetermined petition of the *Peppers Gasoline Co.* v. *Commissioner,* No. 96981, United States Board of Tax Appeals, which exemplifies a situation which compels that taxpayer to *distribute* earnings to avoid the penalty of the tax when debts of more than $150,000.00 (upon some of

which large monthly payments were obligated by written contracts executed and delivered prior to the passage of the law) are outstanding against its business, which obligations were made for physical betterments and improvements constructed *prior to the passage of the law requiring such distribution of earnings.*

That also printed as Appendix Exhibit "C," are copies of briefs in *Northwest Steel Rolling Mills Inc.*, v. *Commissioner*, pending as No. 9207 in the Circuit Court of Appeals for the Ninth Circuit (argued orally December 5, 1939, at San Francisco) but not yet decided.

That the complained of provisions of the Revenue Act of 1936 deny to the Utah Hotel Company, Peppers Gasoline Company and Northwest Steel Rolling Mills Company, as well as a great number of other taxpaying corporations throughout the United States, the due process and equal protection of the laws guaranteed by the Fifth Amendment to the Federal Constitution.

In *Louisville Joint Stock Land Bank* v. *Radford*, 295 U. S. 589, 79 Law. ed. 1605, it was said by Mr. Justice Brandeis that,

> "*Fourth.* The bankruptcy power, *like the other great substantive powers* of Congress is subject to the Fifth Amendment."

The following cases are cited in Note 20 (to the opinion) in support of the conclusion so announced:

> "For instance, the war power, *Ex parte Milligan*, 4 Wall. 2, 119, 18 L. ed. 281, 295; *Ochoa* v. *Hernandez y Morales*, 230 U. S. 139, 153, 154, 57 L. ed. 1427, 1434, 1435, 33 S. Ct. 1033; *Hamilton* v. *Kentucky Distilleries & Warehouse Co.*, 251 U. S. 146, 155, 64 L. ed. 194, 198, 40 S. Ct. 106. *The power to tax, United States* v. *Baltimore & O. R. Co.*, 17 Wall. 322, 21 L. ed. 597; *Boyd* v. *United States*, 116 U. S. 616, 29 L. ed. 746, 6 S. Ct. 524; *Nichols* v. *Coolidge*, 274 U. S. 531, 542, 71 L. ed. 1184, 1192, 47 S. Ct. 710, 52 A. L. R.

1081; *Blodgett* v. *Holden*, 275 U. S. 142, 147, 72 L. ed. 206, 210, 48 S. Ct. 105; *Barclay & Co.* v. *Edwards*, 267 U. S. 442, 450, 69 L. ed. 703, 706, 45 S. Ct. 135, 348; *Heiner* v. *Donnan*, 285 U. S. 312, 326, 76 L. ed. 772, 779, 52 S. Ct. 358. The power to regulate commerce, *Monongahela Nav. Co.* v. *United States*, 148 U. S. 312, 336, 37 L. ed. 463, 471, 13 S. Ct. 622; *United States* v. *Joint Traffic Asso.*, 171 U. S. 505, 571, 43 L. ed. 259, 288, 19 S. Ct. 25; *Carroll* v. *Greenwich Ins. Co.*, 199 U. S. 401, 410, 50 L. ed. 246, 250, 26 S. Ct. 66; *United States* v. *Lynch*, 188 U. S. 445, 471, 47 L. ed. 539, 549, 23 S. Ct. 349; *United States* v. *Cress*, 243 U. S. 316, 326, 61 L. ed. 746, 752, 37 S. Ct. 380. The power to exclude aliens, *Wong Wing* v. *United States*, 163 U. S. 228, 236-238, 41 L. ed. 140, 143, 16 S. Ct. 977. Compare *Perry* v. *United States*, 294 U. S. 330, *ante*, 912, 55 S. Ct. 432, 95 A. L. R. 1335."

(d) The Act in its complained of provisions is unconstitutional and invalid in that it is "arbitrary and capricious so as to amount to confiscation and thereby offend the 5th Amendment" by its imposition of a tax upon a corporation which is without income in a business sense, as where such corporation sustains (in the taxable year) a nondeductible capital loss in excess of its "taxable net gain," or in the alternate penalizes a corporation for failing to do the impossible, viz., the payment of a dividend with nothing on hand out of which to make such payment.

In support of this contention we wish to quote for *purposes of analogy* from Mr. Justice McReynolds' opinion in *Nichols* v. *Coolidge*, 274 U. S. 531, 47 Sup. Ct. Rep. 710, 71 L. ed. 1192, 6 Amer. Fed. Tax Rep. 6758, as follows:

> "Certainly, Congress may lay an excise upon the transfer of property by death reckoned upon the value of the interest which passes thereby. But under the mere guise of reaching something within its powers Congress may not lay a charge upon what is be-

yond them. Taxes are very real things and statutes imposing them are estimated by practical results.

"As the executors paid the contested charge out of property which actually passed by death, only their rights are here involved. If the fund held by them had been insufficient and payment had been exacted from others somewhat different questions might require consideration. Lewellyn v. Frick, supra.

"The statute requires the executors to pay an excise ostensibly laid upon transfer of property by death from Mrs. Coolidge to them but reckoned upon its value plus the value of other property conveyed before the enactment in entire good faith and without contemplation of death. Is the statute, thus construed, within the power of Congress?

"Undoubtedly, Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for purposes of taxation. This is necessary to prevent evasion and give practical effect to the exercise of admitted power, but the right is limited by the necessity.

"Under the theory advanced for the United States, the arbitrary, whimsical and burdensome character of the hallenged tax is plain enough. An excise is prescribed, but the amount of it is made to depend upon past lawful transactions, not testamentary in character and beyond recall. Property of small value transferred before death may have become immensely valuable, and the estate tax, swollen by this, may leave nothing for distribution. Real estate transferred years ago, when of small value, may be worth an enormous sum at the death. If the deceased leaves no estate there can be no tax; if, on the other hand he leaves ten dollars both that and the real estate become liable. Different estates must bear disproportionate burdens determined by what the deceased did one or twenty years before he died. See Frew v. Bowers, (C. C. A. 2d) 12 F. (2d) 625.

"This court has recognized that a statute purporting to tax may be so arbitrary and capricious as

> to amount to confiscation and offend the 5th Amendment. Brushaber v. Union P. R. Co., 240 U. S. 1, 24, 60 L. ed. 493, 504, L. R. A. 1917D, 414, 36 Sup. Ct. Rep. 236, Ann. Cas. 1917B, 713; Barclay & Co. v. Edwards, 267 U. S. 442, 450, 69 L. ed. 703, 706, 45 Sup. Ct. Rep. 348. See also Knowlton v. Moore, 178 U. S. 41, 77, 44 L. ed. 969, 984, 20 Sup. Ct. Rep. 747. And we must conclude that sec. 402(c) of the statute here under consideration, in so far as it requires that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation."

Of further *important* significance in this connection is the opinion of Mr. Justice Sutherland in *Heiner* v. *Donnan,* 285 U. S. 312, 351, 76 Law. ed. 772, which reached the Supreme Court upon *certificate* (in conformity with Sec. 346, title 28, Judicial Code, U. S. C. A.) from the Circuit Court of Appeals for the Third Circuit, *for the opinion* of the Supreme Court of the United States as to whether certain provisions of the statute (then before that circuit for construction) *violated* the due process clause of the Fifth Amendment, which question when answered was answered in the affirmative.

A brief quotation from Mr. Justice Sutherland's opinion in the *Donnan* case will suffice to support the rule announced in *Nichols* v. *Coolidge, supra.* We quote:

> "That a federal statute passed under the taxing power may be so *arbitrary* and *capricious* as to cause it to fall before the due process of law clause of the 5th Amendment is settled."
>
> —*Nichols* v. *Coolidge,* 274 U. S. 531, 71 L. ed. 1184, 52 A. L. R. 1081, 47 Sup. Ct. Rep. 710;
>
> *Brushaber* v. *Union Pac. R. Co.,* 240 U. S. 1, 60 L. ed. 493, 36 Sup. Ct. R. 236;
>
> *Tyler* v. *U. S., supra,* 281 U. S. 504, 74 Law. ed.

Mr. Justice Sutherland then proceeds to quote from *Hoeper* v. *Tax Commission*, 284 U. S. 206, 76 L. ed. 251, 52 Sup. Ct. R. 120, which suggests a further quotation from the opinion of Mr. Justice Roberts in that case as follows:

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"Since, then, in law and in fact, the wife's income is in the fullest degree her separate property and in no sense that of her husband, the question presented is whether the state has power by an income-tax law to measure his tax, not by his own income, but, in part, by that of another. To the problem thus stated, what was said in *Knowlton* v. *Moore*, 178 U. S. 41, 77 44 L. ed. 969, 984, 20 S. Ct. 747, is apposite:

> 'It may be doubted by some, aside from express constitutional restrictions, whether the taxation by Congress of the property of one person, accompanied with an arbitrary provision that the rate of tax shall be fixed with reference to the sum of the property of another, thus bringing about the profound inequality which we have noticed, would not transcend the limitations arising from those fundamental conceptions of free government which underlie all constitutional systems.'

"We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income. (Compare *Nichols* v. *Coolidge*, 274 U. S. 531, 540, 71 L. ed. 1184, 1192, 52 A. L. R. 1081, 47 S. Ct. 710.)

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"It is incorrect to say that the provision of the Wisconsin income tax statute retains or reestablishes what was formerly an incident of the marriage relation. Wisconsin has not made the property of the wife that of her husband nor has it made the income from

her property the income of her husband. Nor has it established joint ownership. The effort to tax B for A's property or income does not make B the owner of that property or income, and whether the state has power to effect such a change of ownership in a particular case is wholly irrelevant when no such effort has been made. Under the law of Wisconsin the income of the wife does not at any moment or to any extent become the property of the husband. He never has any title to it, or controls any part of it. That income remains hers until the tax is paid, and what is left continues to be hers after that payment. The state merely levies a tax upon it. What Wisconsin has done is to tax as a joint income that which under its law is owned separately and thus to secure a higher tax than would be the sum of the taxes on the separate incomes.

"The court below assigned two reasons which it thought removed the constitutional objections to the application of the statute in the instant case. It cited and followed the *Income Tax Cases,* 148 Wis. 456, L. R. A. 1915B, 569, 134 N. W. 673, 135 N. W. 164, Ann. Cas. 1916A, 1147, where the statute here in question was sustained on the ground that the provisions under attack are necessary to prevent frauds and evasions of the tax by married persons, and stated that the decision of this court in *Schlesinger* v. *Wisconsin,* 270 U. S. 230, 70 L. ed. 557, 43 A. L. R. 1224, 46 S. Ct. 260, was not inconsistent with the views expressed by the Supreme Court of Wisconsin in its earlier decision. To this we cannot agree. In the *Schlesinger* case this court held invalid a statute which, for purposes of inheritance tax, classified all gifts *inter vivos,* effective within six years of death, as gifts made in contemplation of death. To the argument of the ne-

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cessity for such classification to prevent frauds and evasions, it was answered:

> 'That is to say, "A" may be required to submit to an exactment forbidden by the Constitution if this seems necessary in order to enable the State readily to collect lawful charges against

"B." Rights guaranteed by the federal Constitution are not to be so lightly treated; they are superior to this supposed necessity. The State is forbidden to deny due process of law or the equal protection of the laws for any purpose whatsoever.'

"The claimed necessity cannot justify the otherwise unconstitutional exaction.

"The second reason assigned as a justification for the imposition of the tax is that it is a regulation of marriage. It is said that the marital relation has always been a matter of concern to the state, and has properly been the subject of legislation which classified it as a distinct subject of regulation. It is suggested that a difference of treatment of married as compared with single persons in the amount of tax imposed may be due to the greater and different privileges enjoyed by the former, and, if so, the discrimination would have a reasonable basis, and constitute permissible classification. This view overlooks several important considerations. In the first place, as is pointed out above, the state has, except in its purely social aspects, taken from the marriage status all the elements which differentiate it from that of the single person. In property, business and economic relations they are the same. It can hardly be claimed that a mere difference in social relations so alters the taxable status of one receiving income as to justify a different measure for the tax.

"Again, it is clear that the law is a revenue measure, and not one imposing regulatory taxes. It levies a tax on 'every person residing within the state' and defines the word 'person' as including 'natural persons, fiduciaries and corporations' and corporations as including 'corporations, (218) joint stock companies, associations or common law trusts.' It lays graduated taxes on the incomes of natural persons and corporations at different rates. It is comprehensive in its provisions regarding gross income and allowable deductions and exemptions, and is in most respects the analogue of the federal income tax acts in force

since 1916. It is obvious that the act does not purport to regulate the status or relationships of any person, natural or artificial. *Arbitrary and discriminatory provisions contained in it cannot be justified by calling them special regulations of the persons or relationships which are the object of the discrimination.* The present case does not fall within the principle that where the legislature, in prohibiting a traffic or transaction as being against the policy of the state, makes a classification, reasonable in itself, its power so to do is not to be denied simply because some innocent article comes within the proscribed class. *Purity Extract Co.* v. *Lynch*, 226 U. S. 192, 204, 57 L. ed. 184, 188, 33 S. Ct. 44. Taxing one person for the property of another is a different matter. There is no room for the suggestion that *qua* the appellant and those similarly situated the act is a reasonable regulation, rather than a tax law.

"Neither of the reasons advanced in support of the validity of the statute as applied to the appellant justifies the resulting discrimination. The exaction is arbitrary and is a denial of due process." (Italics ours.)

We quote (in this connection) from the language of Chief Justice Taft in the *Child Labor Tax case*, 259 U. S. 39, 66 L. ed. 820, 42 Sup. Ct. R. 449, 21 A. L. R. 1432:

"* * * The congressional power over interstate commerce is, within its proper scope, just as complete and unlimited as the congressional power to tax; and the legislative motive in its exercise is just as free from judicial suspicion and inquiry. Yet when Congress threatened to stop interstate commerce in ordinary and necessary commodities, unobjectionable as subjects of transportation, and to deny the same to the people of a state, in order to coerce them into compliance with Congress's regulation of state concerns, the court said this was not in fact regulation of interstate commerce, but rather that of state concerns, and was invalid. So here the so-called tax is a penalty to coerce people of a state to act as Congress wishes

them to act in respect of a matter completely the business of the state government under the Federal Constitution. This case requires, as did the *Dagenhart* Case, the application of the principle announced by Chief Justice Marshall in *McCulloch* v. *Maryland,* 4 Wheat. 316, 423, 4 L. ed. 579, 605, in a much-quoted passage:

> 'Should Congress, in the execution of its powers, adopt measures which are prohibited by the Constitution, or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not intrusted to the government, it would become the painful duty of this tribunal, should a case requiring such a decision come before it, to say that such an act was not the law of the land'."

In the *Peppers Gasoline Company's* case, *supra,* page 54, contracts were entered into in writing for construction costs, before the matter of the complained of legislation was submitted to Congress by the President.

In the *Northwest Steel Rolling Mills Company's* case, the Board of Tax Appeals found (unpublished memorandum opinion) that when

> "* * * petitioner proposed to renew the notes evidencing this indebtedness (in the sum of $150,000.00) in January, 1934, the officer of the bank who was handling this matter stated to the officers of petitioner that a condition of the renewal of these notes would be a payment by petitioner of $1,000 a month in reduction of the principal amount of the indebtedness, *together with the payment on this indebtedness of any available surplus in the treasury of petitioner after the payment of its current operating expenses. Petitioner was given to understand by the officer of the bank in the course of these conversations that in case of a breach of this condition by petitioner the bank would apply for the appointment of a receiver for petitioner's assets.* This condition to the renewal of these notes was not reduced to writing and no written

contract was ever executed by petitioner which dealt with the payment of dividends. From January, 1934, to July, 1936, the amount of petitioner's indebtedness to the bank was reduced to the sum of $85,000, and this amount was paid on July 6, 1936."

Clearly such bona fide transactions come within the rule announced in *Untermyer* v. *Anderson,* 276 U. S. 445, 72 L. ed. 647, 48 Sup. Ct. Rep. 353. We quote from that decision:

"The questions now presented for consideration are similar to those involved in *Blodgett* v. *Holden,* 275 U. S. 142, *ante,* 206, 48 Sup. Ct. Rep. 105.

"The two causes differ in this: Blodgett's gifts were made during January, 1924, before the provisions for taxing such transfers were presented for the consideration of Congress; Untermyer made his gift May 23, 1924, some three months after those provisions were first presented and while the conference report upon the bill was pending. This report went to the Senate May 22, 1924, and three days thereafter the bill had finally passed both houses. The President approved it on June 2, 1924.

"Unless the difference in circumstances stated is material, the same rule of law must govern both cases.

"Two opinions were announced in *Blodgett* v. *Holden.* The one prepared by the present writer expressed the views of four of the eight justices who participated in the consideration of the cause. After quoting the pertinent provisions of the statute, etc., the opinion declared: 'So far as the Revenue Act of 1924 undertakes to impose a tax because of the gifts made during January, 1924, it is arbitrary and invalid under the due process clause of the 5th Amendment.' We need not now further repeat what was there set out.

"In the light of arguments advanced by counsel in the present cause the matter has been considered by all members of the court and a majority of them are of opinion that the gift tax provisions of the Act of 1924 here challenged must be construed as appli-

cable to gifts made during the entire calendar year 1924. And, further, *that so far as applicable to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924, those provisions are arbitrary and invalid under the due process clause of the 5th Amendment.*

"The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from the former one and to relieve the legislation of the arbitrary character there ascribed to it. To accept the contrary view would produce insuperable difficulties touching interpretation and practical application of the statute and render impossible proper understanding of the burden intended to be imposed. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken."

The *four canons* of taxation laid down by Adam Smith in his "Wealth of Nations" are,

(1) equality in distribution,

(2) certainty in amount,

(3) convenience in payment,

and,

(4) economy in collection.

Disregard for the first and second of these basic requirements brings about violation of the revenue and taxation provisions of the Federal Constitution.

The refusal to respect the third and fourth of such requirements brings about the collapse of social structure.

An enlightening consideration of present day tendencies in legislation in their relation to experience in ancient times in these respects, is given in the presidential address of Ar-

thur E. R. Boak before the Michigan Academy of Science, Arts and Letters in Ann Arbor on March 17, last. We print that address as Exhibit "D" in Appendix filed herewith.

Its conclusions are obvious and its citation is not intended as an argument for the exercise of "judicial suspicion or inquiry" into legislative motive for the passage of the complained of statute.

The rules of constitutional interpretation of revenue and taxation legislation which have been consistently adhered to by this Honorable Court, indicate the importance of its context.

While *amici curiae* support the petition for writ of *certiorari,* we do not support the whole of its reasoning. We do not believe the statement (page 11) that,

> "The construction of the court below imputes to Congress an intent to make an indefensible discrimination by allowing rich corporations to avoid the tax while affording no escape to those in failing circumstances, etc.",

is well founded.

The capricious and arbitrary faults in the statutes are not founded upon one's financial condition, but (rich or poor) upon one's ability to read the stars by having in possession a contract executed with creditors (prior to May 1, 1936) in the preparation of which sufficient foresight was employed to have had written the unique guaranty "*that a dividend would not be declared or paid.*"

Whatever else the corporation might anticipate as necessary for exemption allowance under a statute which also had to be anticipated, the failure to have the provision *written into* a contract with creditors that "*dividends would not be paid*", would be fatal to the allowance of exemption which otherwise would go to one successful in guessing just what Congress would grant as its saving grace.

Such requirement could not be more capricious.

See Appendix Exhibit "E" in which are reprinted for comparison purposes sections 14, 26, 27, 102, 115, 117 and 351, of the Revenue Act of 1936, being the provisions of the Act relating to the questions involved herein.

Upon the objection that the act is "abitrary and capricious", in that it undertakes to impose a tax upon a corporation which is without income in a business sense, as where such corporation sustains (in the taxable year) a "non-deductible capital loss" in excess of its "taxable net gain", we think it important to say that such situation cannot be minimized in determining the constitutionality of the complained of statute.

If we assume that an oil or gas mining company should buy a potentially valuable lease in January for $100,000.00—which investment in such lease would be a capital asset under the provisions of section 117 of the Revenue Act of 1936, and by September of the same year exploration has proven the lease of little value and the company then sells (the lease) for $5,000.00, sustaining a $95,000.00 capital loss, the deduction for such loss against other income is limited by section 117 of the Act to the maximum of $2,000.00.

If during the year the same company has realized a net income (as defined by the statute) of $50,000.00 from operations, it has in fact lost $45,000.00 in its complete operations; but under the provisions of the complained of law it must (if in possession of as much as $93,000.00 earnings or profits accumulated in prior years) distribute $48,000.00 or pay a surtax of $9,840.00 *out of a deficit sustained* during such year, and if without sufficient earned surplus to make such distribution, must pay the surtax of $9,840.00 notwithstanding.

Of outstanding significance is the fact that *penalties* imposed by sections 102 (relating to surplus which is said to have been accumulated beyond the needs of the business) and by 351 (the creation of a personal holding company to avoid the collection of surtaxes) are not calculated or imposed until after

allowances (within the provisions of section 102(c)(1)(C) and within the like provisions of section 351(b)(3)(C)) have been made for such capital losses, whereas such *deductions* regardless of the *extent* thereof, are not permitted beyond the allowance of $2,000.00 under section 14, which *arbitrary and capricious formula* discriminatorily affects every operating corporation which respects the fiscal policy of the government in favor of those corporations engaged in an effort to nullify or defeat the fiscal policy of the government.

In other words—all capital losses are deductible under the penalty sections 102 and 351, but limited to an arbitrary deduction of $2,000.00 only (regardless of actual loss) under section 14, affecting ordinary business operation or all operating companies throughout the country.

Such denial of actual operating losses, before calculation of a so-called surtax, violates the 5th Amendment unquestionably.

In this connection we quote from 1938 Cumulative Supplement, The Law of Federal Income Taxation, by Paul & Mertens (pages 314, 315), section 32A.27:

§32A.27.—The Effect of Capital Losses.

A question of importance in connection with the dividends paid credit is whether the capital loss limitation of $2,000, which is continued in the 1936 Act[36] applies to the income subject to undistributed profits surtax. Under the capital loss limitation losses from sales or exchanges of capital assets are allowed only to the extent of $2,000, plus the gains from such sales or exchanges. Under this provision a corporation might have a substan-

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Note 36. 1936 Act, Sec. 117 (d). See Ch. 19 as to this provision.

On this subject see also Fernald, The Tax on Undistributed Profits Imposed by the Revenue Act of 1936, 7 The New York Certified Public Accountant 22, 31 (1936).

The situation discussed in this section has been mentioned as illustrative of the harshness of the undistributed profits surtax and has a possible bearing upon its constitutionality; Hendricks, The Surtax on Undistributed Profits of Corporations, 46 Yale L. J. 19, 49 (1936).

tial net income without having any earnings or profits as a source of distribution of taxable dividends. Dividends[37] are defined as any distribution made by a corporation to its shareholders, (1) out of the earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) without regard to the amount of the earnings or profits at the time the distribution was made. The term "earnings or profits" is not the same as the term "net income,"[38] and a capital loss would affect the computation of "earnings or profits" without being deductible in computing net income. We have in these statutory provisions the possibility of corporate distributions which would not be taxable to the distributee and not, therefore, a good dividends paid credit, although the corporation might have distributed all its current earnings. For instance, a corporation without any previously accumulated earnings or profits, having an ordinary net income of $1,000,000 might have capital losses of $2,000,000. Its earnings or profits account would be $1,000,000 in the red, so that any distribution it made would not be taxable within the meaning of the Act. In such a case the "taxable net income", diminished by the normal tax and the credits provided, would be subject to the undistributed profits surtax, even if distributed, the distribution would not constitute a dividends paid credit.[38a]

Clearly such criticism of the statute in its actual workings is justified, and reveals an *arbitrary standard* that amounts to a deprivation of due process of law and property rights within the prohibitions of the 5th Amendment.

Note 37. 1936 Act, Sec. 115 (a). See § 8.02 Supplement.

Note 38. See Charles F. Ayer, 12 BTA 284; Ida I. McKinney, 32 BTA 450, 454, aff'd in Comm. v. McKinney, 87 F. (2d) 811 (C. C. A. 10th, 1937). See also § 8.37, et seq., particularly § 8.40.

Note 38a. The converse of this example is presented by a case in which the net income is $1,000,000, but earnings are $2,000,000, the difference being "velvet" depletion (the excess of percentage depletion over cost depletion—see § 8.58, Ch. 21). The distribution of $2,000,000

It has been said that the act complained of was hurriedly drawn, and such "arbitrary and capricious" provisions as have been pointed out in the many cases that have arisen over the country, indicate the warrant for that criticism.

This consideration brings to attention the further serious objection; *viz.*, the requirement (to avoid a staggering penalty) of the payment of a "dividend" with nothing on hand out of which to make such payment. A requirement upon the part of the corporation to do the impossible is certainly "arbitrary and capricious", and the Revenue Act of 1936 in its provisions with regard to such unreasonable requirement goes further in "arbitrary and capricious" requirement than any prior statute that has reached this court for interpretation.

The objections to these provisions of the Revenue Act of 1936 are so basic and fundamental as to warrant grave concern in the event of the refusal of this court to review their constitutionality.

It is therefore respectfully urged that this Honorable Court grant its writ of *certiorari*, that it may proceed to review the entire question involved and to thereafter declare and

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would do the corporation no good unless it may carry over the excess. It should be permitted to do so. See § 32A.32.

In some cases all of the earnings may be distributed, e. g., in redemption of corporate obligations previously issued, and no credit would be allowed.

In the Report of the Committee on Federal Taxation to the American Institute of Accountants (submitted September 23, 1937), it is suggested that the discrepancy between *actual* income and *taxable* income, resulting from the limitation of capital losses to $2,000 under Sec. 117 (d) may result in hardship in the application of the undistributed profits surtax, because a corporation might have a large ordinary income which was completely offset by a large capital loss, which would be deductible only to the extent of $2,000 in determining taxable income. It is recommended that this hardship be eliminated by permitting a deduction of the whole amount of the otherwise limited capital loss in computing the "adjusted net income" similar to the provision permitting such a deduction in computing the "special adjusted net income" for the purpose of applying the provision respecting improper accumulation of surplus in Sec. 102.

determine the complained of provisions of the 1936 Revenue Act void and without constitutional authority for the reasons hereinbefore and in the petition for the writ more fully set forth.

HARRY O. GLASSER,
ROBERT L. JUDD,
W. S. GREATHOUSE,
Amici Curiae.